

# THE INTERNATIONAL ECONOMY

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## PREFACE

This book endeavors to set forth as clearly and simply as possible the essential features and theoretical bases of the international economy, with some comment and analysis. It aims to achieve a balance between history, principles, procedure and policies.

The book was begun as a revision of *INTERNATIONAL TRADE AND FINANCE*, but has become largely a new volume. New chapters on trade theory have been introduced and this section now constitutes about one third of the book. Events throughout the world have moved so rapidly that the remaining chapters are in large part also new.

The war has forced the United States to realize the close ties which it has with the rest of the world, and that this country is an integral part of the international economy. The evolution of public opinion and governmental actions in this direction has been slow. The American public has heretofore thought largely in national terms. In the future, however, it will need to expand its sphere of interest.

When we look ahead to the postwar years we are intrigued by the possibilities of a vastly improved economic and political world. Technology and economic knowledge have reached the stage where a reasonably decent standard of living is potentially available to everyone, not merely in the United States but throughout the world. If the world's productive energies, including those directed toward war, could be effectively applied to economic ends, the amount of production available to improve living standards would be great.

When we weigh possibilities as against probabilities, and examine the records of legislative bodies, the activities of pressure groups, the extent of prejudice, misinformation and ignorance, we realize that a better world is not easily obtained.

The postwar period of flux, nevertheless, offers a rare opportunity to make substantial strides. The public everywhere wants

protection against war, assurance of political freedom, economic security and opportunity. They will accept drastic changes, almost any program that gives promise of attaining these ends. Misguided policies, however, whether the result of honest ignorance, or faulty or ulterior leadership, constantly threaten.

The objectives are visualized much more clearly than are the means of attaining them. The type of economic and political arrangements most conducive to the above ends involve differences of opinion; the "social revolution" will continue to be a storm-center. How much free enterprise? How much and what type of regulation? How far shall national sovereignty be surrendered? Do we want a large number of small nations? More important than the location of national boundaries and the size of states are the economic and political arrangements which are established between countries, and the type of institutions guaranteed within.

A world organized economically and politically along lines which would permit approach toward the above aims, would require establishment of conditions which would cause production and trade to expand, and resources to be developed. This means a breaking down of trade barriers and other restrictions, and provision for the flow of capital to areas where it is needed and can be utilized effectively—and there is an abundance of such areas. It also means an attack, internationally, on the causes of depression and underemployment. The public will insist that since governments made industry produce for war, they make it produce for peace, and that the fruits be widely distributed.

The United States will henceforth necessarily play a major rôle in world affairs. Public policy, however, must rest upon widespread knowledge and understanding of the international economy if it is to result in a "better world." In addition to the valuable research in the field of international economics, which often reposes in impressive but little used volumes, there is need for interpretation and wide dissemination of knowledge. The problem is essentially one of public relations. It is hoped that this volume will contribute to a better and wider understanding of the international economy.

## PREFACE

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PART I

NATURE OF THE INTERNATIONAL  
ECONOMY





## CHAPTER 1

### DEVELOPMENT AND NATURE OF INTERNATIONAL TRADE

During the long sweep of history, trade between nations has expanded irregularly, sometimes rapidly and sometimes slowly or not at all. During the last hundred years it has developed spectacularly. Great quantities of goods of all varieties—toothbrushes and tractors, alarm clocks and stoves—are constantly moving from country to country, in and out of the ports of the world. The mass movement of commodities over great distances is a fairly recent development, and the trade of our grandfathers' time was small indeed compared to that of today.<sup>1</sup> This vast increase in foreign trade has given us many articles which we otherwise would not have. It has raised standards of living, and is bringing the countries of the world closer and closer together economically. War interrupts but does not halt this development.

The procession of ships, and now airplanes, coming and going, bearing cargoes and passengers from strange lands, passing Chinese junks and native sampans, sailing completely around the world, riding calmly under equatorial suns, buffeting Atlantic gales, and passing under metropolitan New York's skyline, graphically presents the intimate economic ties which bind the entire world into a single trading unit.

**Trade Depends upon Transportation and Communication.—**  
The remarkable growth of foreign trade has gone hand in

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<sup>1</sup> The foreign trade of the United States, imports and exports combined, increased from \$830,000,000 in 1870 to \$10,250,000,000 in the prosperous year 1929. It declined in 1932 to only \$2,936,100,000, the lowest amount since 1908. A large part of this decline was a value decline rather than a volume decline. The values declined by about one-third over the previous year, while the volume declined by only about one-fifth for exports and one-tenth for imports. After 1932 the United States' foreign trade gradually increased in both value and quantity, and in 1941 amounted to \$8,491,000,000 of which \$5,146,000,000 were exports.

hand with the development of shipping and other transportation and communication facilities. It has also been due to the great technological improvements in industry which have made possible huge increases in the volume and the variety of production. With modern machinery, factories produce vast quantities of commodities which are not to be consumed locally, but which promptly find their way to the four corners of the world. The cargo of a modern vessel is so large that it would fill the holds of a dozen ships of former years. Railroads have replaced primitive methods of transportation and carry bulky loads long distances quickly and at a fraction of the cost of former times. In recent years trucks have become an important factor in the movement of commodities, and airplanes are now carrying significant cargoes long distances.

Ships no longer are dependent upon the vagaries of wind and weather, but reach their destinations on regular schedules and in rapid time. The Atlantic is spanned by modern vessels in four or five days, whereas formerly weeks were necessary. Harbors have been created where they previously did not exist. The Panama Canal has shortened distances and reduced costs of transportation. Aviation has reached across the oceans and linked together the continents. The telegraph and telephone instantly spread news throughout the world, and permit the rapid exchange of ideas and the transaction of ordinary business.

Progress in means of transportation and communication has been so great that the contrast of facilities of today with those of a few generations ago is striking. A person sitting in his home can pick up the telephone and talk with some twenty million other telephones in the United States. He may talk overseas to islands, to countries on the opposite side of the globe, and to ships far from land. Only during the last few decades has it been possible to read news of events outside the immediate locality on the same day that the event occurred.

In 1673 the initial post between New York and Boston was inaugurated with provisions that the postman leave New York once a month, the first Monday, and be back within the month. The post, however, turned out to be very irregular. In 1753

post riders traveled night and day, thereby reducing the time from Philadelphia to Boston to three weeks from the previous six weeks. News of the Battle of Lexington in 1775 did not reach England until six weeks after the battle was over. Even in 1820, three weeks were necessary for vessels to cross the Atlantic.

Shipping developed rapidly after the American Revolution and after the ending of the Napoleonic Wars. The ships were all sailing vessels, but in 1807 Fulton's steamboat made its first trip to Albany, and in 1838 the steamboat *Sirius* arrived in New York in eighteen days from Cork, inaugurating transatlantic steamship service.

Steam was also applied to land transportation, and in 1833 the Baltimore and Ohio was running steam trains from New York to Washington. Soon the principal cities in the eastern part of the United States were connected by railways, which gave active competition to the canals. The Erie Canal had been opened in 1825. Railroads permitted goods to travel overland and reach seaports more directly regardless of rivers and canals. Waterways had theretofore provided the principal means of transportation. Roads were few and usually in extremely poor condition, impassable a large part of the time, so that transportation of goods by land was expensive and impractical.

Although steamships were making good progress in ocean transportation during the first half of the last century, the clipper sailing ships controlled the seas until the time of the Civil War. After the Civil War, both steamships and railroads advanced by leaps and bounds. Wooden sailing vessels gave way to iron steamships driven by screw propellers.

In 1860 the Pony Express from St. Joseph, Missouri, to Sacramento, California, reduced the previous four weeks' time from New York to San Francisco. Eighty riders covered the 1,900 miles from St. Joseph to Sacramento in eight days. Railroad construction, moreover, pushed ahead rapidly, and in 1869 the first transcontinental railway was completed by the Union Pacific. Transportation progress in Europe was similar to that in the United States. In 1830 a railway line was laid between Liverpool and Manchester and promptly proved its prac-

tical utility. Other lines were laid in England and on the continent.

The first transatlantic cable was laid in 1858, following the discovery of gutta-percha insulation. This cable, however, worked for less than two months, so that during the Civil War Europe received no prompt news of events in America. Vessels at that time consumed about two weeks in crossing the Atlantic. Cable communications were finally established on a practical basis in 1866.

At the beginning of the Civil War most cities in the United States were connected by telegraph. In 1876, Alexander Graham Bell invented the telephone and by 1880 over 50,000 telephones were in operation. The great expansion of the telephone, however, came after 1900. In 1927, with the aid of radio, telephone communications were established between New York and London. They have since been extended to include most of the countries of the world, although the war interrupted this expansion. In 1941 the world had 44,200,000 telephones.

The early primitive methods of transportation and communication provide sharp contrast with present facilities, which permit a man to finish his day's business in New York and be on hand in California at the opening of business the following morning, and to talk to all parts of the world without leaving his desk.

Shipping has been greatly benefited and made safer by radio communication. Ships are in constant touch with shore, so that ports know when to expect a vessel and can be ready for its arrival. A ship is enabled to have detailed arrangements made for its cargo, fuel, and other needs. Ships are often instructed as to changes in destination while still far from land, thus saving much time and money. When a ship is in port, modern machinery and mechanical devices make possible prompt loading and unloading even of heavy and bulky objects. An automobile is hoisted aboard like a child's toy, and even railroad locomotives are carried across the seas.

Were it not for these modern facilities which provide quick, reliable, and cheap transportation for goods and passengers, foreign trade would be very limited indeed. Particularly to be

emphasized is the fact of cheap transportation. Were transportation expensive, many goods which now go all over the world would have to stay at home. In fact, they would not be produced at all. Furthermore, we would not have the advantages of large-scale production that we do at present.

**Commodities Come from Many Places.**—Many of the articles which we use daily, often in the most casual and routine ways, come to us, in normal times, from distant parts of the world. Articles supposedly made in America are frequently only partly made here. Our shoes may have been made in St. Louis, but the leather perhaps came from the Argentine. Our clothes may have been made in New England, but the wool was sheared perhaps from sheep in Australia and spun in Manchester, England. Our coffee may be from Brazil or Colombia and the sugar from the Philippines or Cuba; much of our butter normally comes from Denmark, chocolate from West Africa or South America, and the tin in which it was packed may have been from Malaya or Bolivia; the paper in our morning newspaper probably came from wood pulp from Canadian forests, and the rubber in our automobile tires from the Malay Peninsula, the Dutch East Indies, Africa, or Brazil. The wool in our carpets is perhaps from Manchuria (Manchukuo). Rubber which the United States imports may return to its native land in the form of automobile tires. Raw silk for stockings and dresses probably came from Japan or China; furs from Russia, Canada, or China; corks for our numerous bottles doubtless came from Algeria or Portugal, and the shellac on our furniture from India. We might go on indefinitely, mentioning telephones, fountain pens, and radios. It is clear that foreign trade is a matter of concern to everyone, as the disruptions caused by the war emphasize.

The continuous flow of goods in and out of a country, and the dependence of every nation upon foreign trade for many articles, make the world increasingly an economic unit. The intimate relations of each country with other countries, economic, financial, and cultural, have made isolation a thing of the past, although the United States required a severe jolt

before it fully realized this. It is not possible for a nation to shut itself off from the rest of the world.

The civilization and ideas of the developed and so-called advanced nations are spreading into the remote and backward parts of the world. Although bad may go along with the good, the process continues and is inevitable. As a result of shipments of commodities, of magazines, books, and moving picture films, and through radio broadcasting, nations are being fitted to a similar pattern. They are more and more adopting similar methods of living and thinking. American saxophones and automobiles go to Shanghai, and oriental luxuries come to this country. The latest Broadway hit is played in the remote cities of Africa or South America. National differences in dress, customs, and traditions are gradually disappearing—unfortunately in many cases.

Foreign trade will continue to grow in volume and importance in spite of temporary ups and downs. The economic forces behind the interchange of goods and ideas are too strong to be overcome by political barriers and other artificial restrictions which sprang up in so many forms, particularly following the 1929 collapse. These obstacles, and then the war, have been a severe handicap to foreign trade and to economic well-being, but they cannot prevent continuance of the upward trend.

**Trade Is Exchange of Commodities and Services.**—Trade between nations is largely trade between individuals—a simple fact which is often lost sight of. All trade, whether domestic or foreign, is merely an exchange of goods or services by one party for the goods or services of another party, although the monetary aspects of the transactions tend to conceal this. When we speak of Brazil sending coffee to the United States, we mean that individuals or businesses in the United States have bought coffee from individuals or business houses in Brazil. The imports of the United States are made up of thousands of transactions that have been the result of negotiations between someone in the United States and someone in a foreign country. The negotiations may be long-drawn-out and involve much correspondence, or they may be consummated quickly by tele-

graph or telephone. Once trade between two points has been established, it tends to continue, just as domestically buyers tend to patronize the same store.

Governments have increasingly been parties to foreign trade transactions, often buying or selling commodities directly. Thus, the Chinese Government in 1933 bought wheat and cotton in the United States, with money provided by the United States Government. The United States Government has bought large quantities of silver in foreign countries and brought it to this country. During and prior to the war the United States Government bought large quantities of foreign metals, rubber, and other goods. Practically all trade with Russia is, of course, with the Soviet Government or with agencies of the government. In general, however, foreign trade is carried on by private individuals or businesses who decide what to buy, when, where, and how much to buy.

Goods exported to foreign countries are sometimes mistakenly regarded as being surplus goods, the thought being that we produce more than we can consume at home and therefore export the surplus. This reasoning involves a well-recognized economic fallacy. It is true that occasionally a producer finds himself with more goods than he can profitably dispose of and so seeks an additional market, which may or may not be abroad. Producers normally produce for a definite market, and the foreign market is no more an outlet for surplus goods than is the home market.

Potatoes grown by a farmer who grows more than he can himself consume are not regarded as being surplus potatoes. Similarly, goods produced by American firms and sold abroad are not surplus goods in any legitimate sense. They are produced deliberately and with a specific market in mind. American automobiles are manufactured with a right-hand drive for export to China and other countries where traffic rules make such cars preferable. To a producer the foreign market is fundamentally not very different from the domestic market, although it has special characteristics discussed below.

The dual nature of trade is often overlooked and is thereby a source of confusion. Goods are exported in order that other

goods may be received in return. When a person swaps his automobile for a piece of real estate, the simple nature of the trade is clear. Similarly, foreign trade is merely an exchange of our goods or services for those of the foreigner. The interjection of money and bills of exchange into the transaction does not change its nature. Failure to understand this simple fact has sometimes led to unsound national policies. Foreign trade is carried on by individuals and businesses essentially in the same manner that domestic trade is carried on, and for similar reasons. Trade inevitably has two sides—giving something and receiving something in return.

It is often assumed that exporting, i.e., selling to the foreigner, is beneficial and to be encouraged, but that importing, or buying from the foreigner, is undesirable, and should be reduced to a minimum. We are urged to buy at home instead. Such ideas are obviously based upon a false conception of the real nature of trade. Importing is beneficial, as is exporting. The fact that foreign trade is conducted in terms of money, rather than by barter, and that the person who exports merchandise receives money instead of other merchandise, the importer of the other merchandise being a different person from the exporter, tends to conceal the real nature of the trade. If we export but endeavor not to import from abroad, we are parting with goods and services and interfering with the benefit from the transaction. The simple and elementary nature of trade should be firmly fixed in mind if we are not to be misled by confusing arguments and policies regarding foreign trade.

**Foreign Trade and Domestic Trade.**—The parties to a foreign trade transaction may be on opposite sides of the world, or may merely face each other across a river or national boundary. The distance is not the significant part of foreign trade, nor does it distinguish foreign from domestic trade, even though foreign trade usually involves a much longer journey than does domestic trade. Although goods may travel thousands of miles, if they do not cross a political boundary the trade remains domestic. The minute they cross a border the



trade becomes foreign trade. This difference may seem artificial and perhaps appear of no great significance, but a political boundary is a matter of considerable importance to trade. From the broad economic standpoint, there is very little fundamental difference between domestic trade and foreign trade. The existence of political boundaries, however, leads to several important consequences.

In the first place, the border may, and in fact usually does, involve a barrier to the free movement of goods. Tariffs, fees, and licenses make more difficult and sometimes impossible the shipment of goods across a border; they tend to discourage trade. Various bothersome matters complicate foreign transactions and make the business man prefer domestic trade unless sufficiently attractive inducements exist. Oftentimes a complete, or almost complete, embargo prohibits the movement of certain articles.

Secondly, the buyer of foreign goods must pay for them in a different kind of money from that which he is accustomed to use in his own country; or, if the buyer is permitted to pay in his own kind of money, then the seller must convert the proceeds of the sale into his, the seller's, kind of money. One or the other must exchange his money for a foreign money. For example, if a man in Boston buys goods from a man in Montreal, the Canadian seller must either receive payment in American dollars, or else the American buyer must purchase a draft payable in Canadian dollars. Whatever may be the arrangements which have been agreed upon between buyer and seller, foreign trade transactions necessarily involve the conversion of one kind of money, the money paid by the buyer, into another kind of money, the money used by the seller, unless the seller should wish to leave the proceeds of the sale abroad.

Thirdly, foreign trade has to contend with differences as between buyers and sellers, in language, laws, customs, and forms of government. These greatly affect the conduct as well as the course of foreign trade. Evidence of this is found in the fact that trade tends to flow more freely between countries having similar racial, cultural, and political institutions and characteristics. Domestic trade, it is true, frequently has to consider

local laws and different governmental units, but not in the same degree as foreign trade, nor does it involve or have to contend with very great racial and social differences between buyers and sellers. Most countries are fairly homogeneous within themselves as regards language, customs, and social characteristics. Foreign traders, however, must be familiar with the laws, practices, and customs prevailing in the nation with which they are trading. Goods destined for a foreign market must often be of a different type from those prepared for the domestic market, and may be sold under different conditions.

Fourthly, production in each country is carried on under economic and financial conditions peculiar to that country. Wage rates, taxation, the prices of certain materials, and the cost of capital vary widely from country to country. Labor and capital are much more mobile within a country than between countries, so that those differences in relative costs persist. The producers of one country do not compete to any great extent with foreign producers for certain materials and agents of production. They ordinarily do not compete for the same workers, land, or other items necessary to production. Such lack of competition, of course, sometimes exists in different parts of the same country, but domestic trade, nonetheless, does not have the great differences along these lines that influence production costs of the various countries.<sup>2</sup>

Various estimates have been made regarding what percentage the foreign trade of the United States is of this country's domestic trade. Accurate figures are available on the foreign trade of this country, since it must pass through definite ports where careful records are kept and control exercised by the federal government. Domestic trade, however, is so complex in its nature and so decentralized, that only estimates are possible. The Department of Commerce has estimated that of the movable commodities produced within the United States on the basis of value about one-tenth, under ordinary circumstances, is exported annually.<sup>3</sup>

<sup>2</sup> Professor Angell makes a distinction between domestic trade and foreign trade in the greater transportation costs in foreign trade. He calls this a quantitative difference. James W. Angell, *Theory of International Prices*.

<sup>3</sup> Were it not for U. S. high tariff policy, foreign trade would be larger.

Exports and imports combined have in recent years been somewhat less than 10% of the country's national income, as the accompanying table shows. These years, it is to be remembered, were ones of international disturbance when foreign trade encountered severe difficulties. The figures, moreover, do not include invisible trade, but only merchandise transactions.

	National Income	Value of Foreign Trade
1935.....	\$58,728,000,000	\$4,330,000,000
1936.....	68,116,000,000	4,835,000,000
1937.....	72,213,000,000	6,429,000,000
1938.....	66,584,000,000	5,055,000,000
1939.....	71,016,000,000	5,496,000,000
1940.....	75,706,000,000	6,647,000,000
1941.....	89,540,000,000	8,491,000,000

Such figures, of course, do not necessarily measure the relative importance of foreign as against domestic trade. They are sometimes misused to imply that foreign trade is of no great consequence because in value it is only a small per cent of our total trade. The importance of foreign trade, however, cannot be measured in such mechanical fashion. We do not estimate the importance of our morning paper by the small amount we spend for it. In foreign trade, many factors incapable of measurement are involved. The benefits derived from foreign trade are great, and are discussed in the following pages.

## CHAPTER 2

### HISTORY OF INTERNATIONAL TRADE

**Beginnings of International Trade.**—If we turn back the pages of history we find the early periods of commerce shrouded in mystery and legend. Nonetheless, in remote antiquity are traces of an extended commerce. We do not know exactly the extent or nature of this trade of the ancients, but we know that it existed and involved long distances. For perhaps several thousand years before present European countries took form, commerce existed between such widely separated points as China, India, and the Baltic regions of northern Europe. In the fourth century B.C. Greece was regularly receiving raw silk from China and weaving it into cloth, which was extremely expensive. The flow of goods between China and the West was interrupted in 1453 when the Turks captured Constantinople. Whether ancient trade came in contact with the western hemisphere we can only surmise, but Carthaginian coins have been found in the Azores, nearly half way across the Atlantic. Figures distinctly oriental in nature have been found in the ancient ruins of Mexico and in other parts of the Americas.

From earliest times, commerce has contributed greatly to the progress of mankind. Through trade, the civilization and cultures of advanced peoples have spread into backward areas, and stimulated progress there. The search for trade routes has led to the discovery of new regions, and their consequent development. As a result of trade, different civilizations have met, and each benefited by the other. Trade brings new methods and new ideas. Throughout all history trade has gradually tended to break down the differences and contrasts of the trading areas. Today the entire world is an economic unit, and in large measure lives the same general type of life. It sees the same

movies, wears similar kinds of clothes, rides in the same kinds of automobiles, and shoots the same kinds of guns. It still speaks different languages, but even this difference is becoming less all over the world—educated people are learning to speak English. This language may eventually become the world's language.

International commerce appears to have developed very early along the traveled desert routes, thousands of years before Christ. Caravans of camels driven by Arab nomads carried the wares of ancient northern Africa, and exchanged them for the products of the civilizations of the Tigris-Euphrates valley, Babylonia, and later Assyria. The Arabs, familiar with the desert, established oases as *entrepôts* and resting stations in connection with this trade. Organized in large caravans to ward off marauders, the Arab traders themselves became robbers when such operations attracted them. Whether traders or brigands, they would dispose of their wares in colorful bazaars, where dates, wool, and garments were exchanged for olive oil, spices, drugs, dyes, and ornaments. Goods carried on these caravans were necessarily those which combined high value with small bulk, principally luxuries. Necessities did not as yet figure in long-distance trade. Later, products were traded between Egypt and Mesopotamia along the Tigris and Euphrates rivers. Shipments included timber, stone, and corn, in addition to the other goods mentioned.

Little is known about the trade of the early civilizations in the western hemisphere, but it is apparent that considerable trade existed there. In China, trade appeared several thousand years before Christ—how far back we do not know—and contributed to the early oriental civilization. Until recent years China has been self-satisfied and did not encourage foreign traders. Nonetheless, trade with foreign nations took place, largely on the initiative of the foreigners. The modern period of trade between China and the West dates from 1516, when European sailors appeared at Canton. Japan was not opened to foreign trade until the middle of the last century.

The first important sea-going people appear to have been the inhabitants of the island of Crete, in the eastern Mediter-

anean. From about 2500 to 1500 B.C., the Cretans maintained a commerce which embraced Egypt, Sardinia, and the Aegean area. Articles traded included such luxury products as paintings, sculpture, gems, pottery, ivory, fine fabrics, and inlaid work. Egypt and Mesopotamia were still great powers when the sea assumed a commercial importance.

During these early periods, and in fact until recent times, commerce has had to contend with robbers and pirates. Commerce was thus seriously hampered by the unsafe conditions of travel. Traders ordinarily had to provide their own protection, and the difference between a trader and a pirate often was not great. Another great handicap to trade was the inadequacy of transportation facilities. Only in modern times has transportation permitted the mass movement of commodities, and made foreign articles available to the common man.

**The Phoenicians.**—The Cretan Age came to an end with the rise of the Phoenicians, an energetic Semitic race which inhabited the eastern shores of the Mediterranean. The Phoenicians established the great trading cities of Tyre and Sidon in Syria, and the colony of Carthage on the north African coast. Carthage, founded before 800 B.C., eventually overshadowed all the other Phoenician cities.

The Phoenicians were pioneers in the art of shipbuilding, and made frequent voyages to the western Mediterranean and beyond. Shut off from the inland by a range of mountains, the Phoenicians logically took to the sea. For four centuries the Phoenicians were a preeminent maritime people, carrying on a thriving commerce between the various regions of the entire known world. Metal articles, glassware, and textiles were shipped to the western Mediterranean peoples in exchange for tin, copper, and silver. The Phoenicians controlled and worked copper mines in Spain. A great land trade was established with central Africa, from which ivory, Negro slaves, and gems were secured and sold to the Mediterranean peoples. The Phoenicians also established commercial relations with India, which they reached by crossing the Isthmus of Suez. In exchange for the products of the East, the Phoenicians shipped gold and

spices from Asia Minor and Arabia, tin from Gaul, iron from Lorraine, corn and linen from Egypt, slaves from Africa, and wine from Italy and Greece.

The extent of the rich commerce of Tyre is indicated from the following biblical passage written in the sixth century B.C. by the prophet Ezekiel:

Tyre, O thou that dwellest at the entry of the sea, which art the merchant of the peoples unto many isles, . . . thy borders are in the heart of the seas; thy builders have perfected thy beauty. They have made all thy planks of fir trees from Senir; they have taken cedars from Lebanon to make a mast for thee. Of the oaks of Bashan have they made thine oars; they have made thy benches of ivory inlaid in boxwood, from the isles of Kittim. Of fine linen with brodered work from Egypt was thy sail, that it might be to thee for an ensign; blue and purple from the isles of Elishah was thine awning. . . .

Tarshish was thy merchant by reason of the multitude of all kinds of riches; with silver, iron, tin, and lead, they traded for thy wares. Javan, Tubal, and Meshech, they were thy traffickers: they traded the persons of men and vessels of brass for thy merchandise. They of the house of Togarmah traded for thy wares with horses and war-horses and mules. The men of Dedan were thy traffickers: many isles were the mart of thy hand: they brought thee in exchange horns of ivory and ebony. Syria was thy merchant by reason of the multitude of thy handiworks: they traded for thy wares with emeralds, purple, and brodered work, and fine linen, and coral, and rubies. Judah, and the land of Israel, they were thy traffickers: they traded for thy merchandise wheat of Minnith, and pannag [perhaps a kind of confection], and honey, and oil, and balm. Damascus was thy merchant for the multitude of thy handiworks, by reason of the multitude of all kinds of riches; with the wine of Helbon, and white wool. Vedan and Javan traded with yarn for thy wares: bright iron, cassia, and calamus were among thy merchandise. Dedan was thy trafficker in precious cloths for riding. Arabia, and all the princes of Kedar, they were the merchants of thy hand; in lambs, and rams, and goats, in these were they thy merchants. The traffickers of Sheba and Raamah, they were thy traffickers: they traded for thy wares with chief of all spices, and with all precious stones, and gold. Haran and Canneh and Eden, the traffickers of Sheba, Asshur, and Chilmad, were thy traffickers. They were thy traffickers in choice wares, in wrappings of blue and brodered work, and in chests of rich apparel, bound with cords and made of cedar, among thy merchandise. The ships of

Tarshish were thy caravans for thy merchandise: and thou wast replenished, and made very glorious in the heart of the seas.<sup>1</sup>

**Early Forms of Money Used in Commerce.**—To what extent money figured in Phoenician commerce is not certain. Various forms of money were in use prior to this period, but it appears that in the commerce of the Phoenicians most of the exchanges were made on the basis of goods.

At what date gold and silver came into use as money to help transact trade is not known, but there is evidence that in Babylonia and Egypt some three or four thousand years before Christ, gold and silver, particularly silver, were used as money in the form of uncoined bars. They were accepted entirely by weight. Gold bullion apparently served as money in China about two thousand years before Christ. Money appears to have been coined in China about 600 B.C. Coins first appeared in the Mediterranean countries in Lydia about 700 B.C. Croesus minted gold coins there in the sixth century B.C. from gold obtained from his famous gold mines. Most of the metallic money in these early periods was in the form of lumps, bars, or rings. They were stamped to show their weight and also had the inscription of the ruler. Iron money circulated in Sparta, and uncoined copper in ancient Rome. Leather representative money was used in Carthage. The Greeks were instrumental in extending the use of coined money, and Athens maintained a silver currency which gained wide acceptance.

Commodities of various types have served as money to transact trade from the very earliest times and even down to the present in some of the outlying parts of the world. Commodities so used include cattle, sheep, knives, skins, shells, pieces of cloth, grain, cacao, tobacco, olive oil, rice, salt, and many other articles.

In China the use of paper money was fully developed in very early times. Other countries lacked paper, but they used various other materials as representative money on the same principle. In China over a century before Christ an emperor issued white leather tokens made from white deer, after all of this type of

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<sup>1</sup> *Ezekiel*, 27:3-7, 12-25.



deer had been corralled in a park so that no one else could put out similar money. Marco Polo, in the thirteenth century, found paper money of various values circulating in China. Although paper money has been used for many centuries, the present widespread use of it is a modern development. The history of paper money throughout the various parts of the world records frequent abuse, over-issue and depreciation, with disturbing effects upon trade and commerce.

**Greek and Roman Commerce.**—The Phoenicians eventually relinquished maritime supremacy to the Greeks, and were driven out of the Aegean and Ionian Seas. By 500 B.C., Greek commerce had assumed substantial proportions, and provided the economic foundation for Greek culture. The wealth of Greece was immeasurably increased by the activities of its energetic traders and shippers. The Greeks exported olive oil, figs, honey, pottery, fabrics, and metals. With the conquests of Alexander in the fourth century B.C., the Greeks were enabled to develop a trade with central Asia. Trade was also carried on with India. As a result of Greek commerce, the cities of Antioch and Alexandria in the eastern Mediterranean came to have great importance as trading centers.

The Romans were less commercial in temperament than the Greeks, and during their early development showed little interest in trade. Commerce, however, was an inevitable accompaniment of imperial aspirations. The extension of the Roman empire and the establishment of law and order over so much of the known world gave commerce a more solid foundation than ever before. The entire known world at that time was united in trade, which extended from China to Britain and the Baltic regions in northern Europe. During the *pax romana*, or period of peace, which began in 29 B.C. and lasted for over two centuries, Rome enjoyed great prosperity, and trade flourished without disturbance. Roman commerce followed the general pattern laid down by the Greeks. Trade between East and West was greatly expanded. About the middle of the first century A.D., the secrets of the monsoon winds in the Indian Ocean were discovered, and facilitated navigation to India.

Commodities entering into commerce during this era were marble from Greece, flax and papyrus from Egypt, metals from Britain and Asia, glass and leather from Gaul, perfumes from Syria, ivory, ebony, and slaves from Africa, silk from China, furs and gems from Scythia, hides from Asia Minor, parchment from Pergamum, amber from the Baltic and Germany, and timber from Syria and Africa. Rome imported huge quantities of corn from Egypt to support its growing population.

**Byzantine Commerce.**—With the fall of Rome in the fifth century, Constantinople became the great commercial center of the world and continued supreme in this capacity until the time of the Crusades. Constantinople acquired a wide reputation for its excellent manufactures. Its porcelains, fabrics, exquisitely engraved metal articles, carved ivories, and mosaics were highly prized in the markets of East and West.

Mohammedanism emerged in the early seventh century in Arabia, and spread rapidly. In 637 the Arab disciples of Mohammed, known as Saracens, captured Antioch and in 641 subdued Alexandria. The conquest of other countries continued until the Saracen Dominion included Persia, Syria, Egypt, north Africa, and Spain. During the seventh and eighth centuries the Arab disciples of the new religion were the outstanding traders of the world. At first the Saracens placed their militant religion before trade. Gradually, however, their commercial interests took more and more of their attention. The Saracens visited China regularly and carried on a thriving trade with India. In Spain and Sicily they introduced Eastern agricultural plants and industries, thus affecting the commerce of these regions.

Several of our modern institutions for facilitating trade, such as banking and insurance, had their beginnings in Constantinople. Credit notes were used, and loans were available at relatively moderate rates of interest. The monetary unit was the gold *bezant*, which found general acceptance. Token money in the form of iron coins circulated for smaller transactions. Facilities were also developed for insuring shipments of merchandise. Great fairs were instituted at Constantinople and

Thessalonica where traders from all over the world could dispose of their wares. At these fairs a high degree of freedom of trade prevailed. The Saracens devised the Arabic or decimal system of notation, and improved notably the scientific learning and culture acquired from earlier civilizations.

**Characteristics of Medieval Trade.**—International trade during the early Middle Ages was relatively small in volume. With the decline of Roman roads and the general disorganization accompanying the barbarian invasions, commerce almost disappeared. The network of highways from Persia on the east to Britain on the west fell to pieces. The independent nobles lived a simple and local life. In Italy, however, trade did not completely die out, as noted in the next section.

During this period each feudal manor was a self-sufficient unit in which practically all the necessities of life were produced. Salt and a few other items, however, were acquired from outside by trade. The principle of trade was condemned by the Church. Trade was considered barren, and it was believed that if one party to a trade gained, the other party lost. Traders were usually unbelieving Jews and Arabs, and were scorned as a class by Christians.

With the rise of towns, this narrow conception of trade became outmoded, and commerce ceased to be looked upon as an illegitimate occupation. The development of guilds, with various social and religious as well as business functions, gave dignity to the status of the merchant. Every town had a market place where, on certain days, goods made by craftsmen could be exchanged for farm produce. Goods could be traded only at the market place and only on market days. What the market place was to a town, the fair was to a larger region. Fairs were generally held once a year, and were frequented by merchants from outside countries who often came long distances. Goods of every description and from many localities were brought here, and were bought and sold.

Except at the fairs, medieval commerce was subject to numerous restrictions. Guilds exercised strict regulation over prices and workmanship. Each guild, moreover, monopolized

a particular industry in the town in which it was located, so that competition was absent. Trade between different areas was impeded by numerous customs, duties, tolls, and taxes. The movement of commodities between towns, provinces, and foreign countries thus had to contend with many barriers of this nature and was seriously handicapped. The modern system of tariffs and other trade barriers thus has its roots in medieval practices.

**Commerce of the Italian Towns.**—The heirs to the commerce of Constantinople were the independent cities of Venice, Genoa, Naples, Florence, Milan, Pisa, etc. Even before the Crusades, the Italian towns had developed a considerable Mediterranean commerce. The Crusades, however, enabled them to extend greatly their activities. Out of the intense rivalry between these towns, Venice emerged supreme and became the most powerful city of the Middle Ages.

In the eleventh century, the Arabs were driven from Sicily, and the Christians assumed the offensive in the wars of religion. The Crusades, which had for their objective the recovery of the Holy Land from the Saracens, began in 1095 and covered a period of almost two centuries. The fleets accompanying these Crusades were fitted out with munitions and food by merchants in Venice, Genoa, Pisa, and other Italian ports. The merchants saw to it that they were rewarded for their services, as having assigned to them a definite quarter in a captured town where their trade could be centered. Venice sent governors to Jerusalem to preside over the quarters there assigned to its citizens. The Italian cities received coveted commercial concessions in Syria and Palestine and developed an active trade with this area. After the Fourth Crusade, Venice seized important provinces of the Byzantine Empire.

Italian bankers engaged in extensive banking operations and succeeded in replacing, to a large extent, the Jews who had monopolized this field. During the late twelfth and early thirteenth centuries the Papacy set up extensive financial machinery, and made use of the facilities of the Italian bankers. They were protected by the Church from the ban on usury, and in spite of their high interest rates, were an aid to the commerce which was

emerging from the Dark Ages. They loaned money, received deposits, and employed bills of exchange. The Florentines, Lombards and Venetians established agencies in the principal cities of Europe to carry on the financial affairs of the Church. The street in London where the Lombards lived and followed their occupation became known as Lombard street, and is today the principal financial street in London. Commerce was greatly facilitated by the development of banking and improvements in keeping of accounts. The coinage of this period was in very bad shape and handicapped trade. Banking tended to relieve this situation somewhat by helping to standardize monetary units for accounting purposes. The Venetian gold ducat was first coined in 1284 and became the leading currency of the world.

The Crusades revived the trade between Europe and the East, and paved the way for the subsequent great expansion in this commerce. The Crusaders returned from Palestine much impressed with the comforts and luxuries of their foes. Such luxuries as window glass, artificial light, and chimneys were introduced into Europe as a result of the Crusades, and gradually a large demand for Eastern spices, silks, calicoes, perfumes, and gems was developed. Other Eastern products were camphor, musk, pearls, carpets, ivory, and porcelain from China. These wares eventually found their way through the Italian cities into France, Germany, and other parts of Europe where the people marveled at these luxuries and greatly enjoyed them.

These new goods and the desire to possess them stimulated production in Europe. The effects of their introduction into Europe were profound. The people endeavored to produce a surplus of goods over their own needs so that they might have goods to trade for these Eastern luxuries. European production thus expanded greatly. Cloth manufactured in England, France, Flanders, and Italy was shipped regularly from the Italian ports to the East, as were wines and other goods. A special market for Western cloth was established in Cairo. The exports of Europe, however, were inadequate, so that gold and silver left Europe in large quantities to pay for the imported articles.

As the precious metals were drained from Europe to the East, their value increased, or, in other words, commodity prices declined. This appreciation of gold and silver stimulated the search for the metals and led to the explorations in America. The principal aim of the explorers was to obtain treasure. Their efforts were well rewarded.

From early in the fourteenth century, a large fleet of galleys annually made the voyage from the Italian ports to the western Mediterranean and through the Strait of Gibraltar to the low countries. This voyage was publicly controlled. Space on the ships was auctioned to individual merchants and goods were carried for their respective accounts. The ultimate destination of the voyage was usually Bruges in Flanders, which at that time was the great trading city of northwestern Europe. A part of the fleet frequently put in at London or Southampton. Spices, indigo, silks, wines, and raisins from the south were exchanged for metals, wool, hides, and later, manufactures.

**Hanseatic League.**—The great expansion of production and trade in Europe during the Middle Ages stimulated the growth of towns. The trade of the towns, however, was handicapped by the large amount of piracy prevailing. In the North Sea, pirates were numerous and were constantly preying upon shipping. Furthermore, according to the so-called Strand laws, if a ship were driven ashore, for whatever reason, it became the property of the owner of the coast. In order to reduce these and other hazards, the towns made agreements with one another, the aim being to promote trade. The towns formed themselves into unions, the best known of these being the Hanseatic League, made up chiefly of German cities. The Hanseatic League was formed in the early fourteenth century and dominated the commercial and political life of northern Europe for nearly three centuries.

Embracing almost a hundred cities, including Cologne, Danzig, and Lubeck, the League was in reality a great commercial state. It had its own assembly, courts, treasury, fleets, and army. It waged war successfully against the King of Denmark and against England. It fought the pirates and made sea

traffic much safer. Merchant ships, however, did not sail alone, but in fleets accompanied by vessels of war for protection.

A principal purpose of the League was to secure trade concessions from foreign rulers. The merchants of this period did not trade as individuals but as members of a certain merchant guild and from a certain town. They thus enjoyed the treaties made by the town, or group of towns. The privileges obtained by the Hanseatic League were extensive and were reserved exclusively for members. The League controlled nearly all the trade on the Baltic and North Seas. It established and controlled its own settlements and trade depots in London, Bruges, Bergen, and Novgorod. The merchants prospered, and as their wealth increased their status in society was raised. They became leading and influential members of the community. Their wealth permitted them to enjoy an education, and they assumed a position of importance alongside the clergy and nobility.

Several features of the modern capitalistic system developed in this period. As fortunes were amassed out of productive enterprises, wealthy families appeared, among them the famous Fugger family of Augsburg, Germany. Descended from an enterprising weaver who on his death in 1408 had left substantial savings, this family engaged in extensive financial and commercial operations during the fifteenth and sixteenth centuries. Under the leadership of the able Jacob Fugger, the family traded in spices, silk, and wool in nearly all the European countries. The Fuggers owned copper mines in Hungary, and silver mines in Tyrol. By 1500 they were the leading bankers in Europe, having acquired a huge fortune from which they made large loans to the Pope and the Holy Roman Emperor. Their investments in Spanish shipping and colonization were particularly successful. By the middle of the sixteenth century, this family had built up a fortune of many millions of dollars.<sup>2</sup>

**Europe Looks Westward.**—During the fifteenth century occurred developments which shifted the center of trade from

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<sup>2</sup> Carlton J. H. Hayes, *A Political and Cultural History of Modern Europe*, New York, The Macmillan Company, 1932, Vol. I, p. 89. See also H. Gordon Selfridge, *The Romance of Commerce*, London, John Lane, the Bodley Head, Ltd., 1923, Ch. V, "The Fuggers of Augsburg."

the Mediterranean to the Atlantic. The first of these was the capture of Constantinople by the Turks in 1453. This interfered with the well-established commerce between Europe, particularly that of the Italian cities, and the East. The goods which India and the East sent to Europe were of small bulk—silks, satins, perfumes, spices, and perhaps narcotics. These could travel over the long desert routes, but the goods of Europe were heavier and more cumbersome. Thus it was that the precious metals went from Europe to the East; their increasing scarcity in Europe enhanced their value and led to a search for new sources of supply.

The result of these developments was active exploration, and the search for a new route to India. Navigation had been stimulated by the traffic in slaves from Africa, as well as by the lure of the East and the vivid stories of returned traders. The Polo brothers, Venetian merchants, had visited Peking and been entertained by the Mongol emperor. Marco Polo, a son of one of the brothers, accompanied them on a second trip, and after his return to Venice in 1295, having been gone twenty years, amazed the people with his accounts of the Far East and of the gold of Japan.

Explorers ventured farther and farther. Cape Verde was reached in 1445, and the Cape of Good Hope in 1488 by Bartholomew Diaz. Diaz rounded the Cape but did not proceed to India. The route to India was discovered when Vasco da Gama, a Portuguese captain, made the complete journey to India in 1498 by way of the Cape of Good Hope.

In 1492, Christopher Columbus, seeking a route to India as well as gold, sailed westward under the flag of Spain and reached the Caribbean islands, which he believed to be just off the coast of Asia. About four years after Columbus' return, John Cabot sailed from England, via Iceland, and apparently reached the shores of Newfoundland. In a few years it was found that these islands which Columbus had discovered, and the continent to the west were part of the "new world," which contained tremendous natural wealth. The gold which Columbus and other explorers brought back stimulated further adventure and discovery, with profound consequences. Soon the new



world occupied the attention of Europe, and poured the precious metals into Europe.

In trading with the new world, the best situated country was not Italy nor the Baltic countries, but Britain. British supremacy in trade, however, was not attained easily nor until after a series of wars covering three centuries. These wars brought about the successive elimination of Portugal, Spain, Holland, and France as contenders for commercial supremacy.

**Portuguese and Spanish Commercial Domination.**—During the fifteenth century, Spain and Portugal were the leading sponsors of overseas exploration. Accordingly, in 1493 the Pope divided all new lands between these two countries. A “line of demarcation” was drawn from pole to pole 370 leagues west of the Azores. All new lands east of this line were conferred upon Portugal and all unexplored territory west of the line was granted to Spain. Thus Portugal secured Brazil and most of Africa and Asia, while Spain gained North America and most of South America.

For more than 50 years, Portugal engaged in an exceedingly profitable commerce with the coasts of Africa, India, and the East Indies. Portugal, however, small in size and with limited resources, was unable to prevent other European nations from encroaching upon its claims. The Netherlands, in particular, took advantage of Portugal’s weakness. The Dutch organized expeditions to Asia which openly attacked Portuguese vessels and which, through intrigue, aroused the opposition of native rulers to Portugal. Spain violated the papal treaty of 1493 by taking possession of the Philippine Islands, which were situated in the Portuguese hemisphere.

Upon the death of the last male heir of the Portuguese royal family in 1580, King Philip of Spain, the next in descent through a female line, became King of Portugal, and annexed Portugal to Spain. The destruction of the Spanish Armada in 1588 by England definitely put an end to Portuguese commercial domination, since it led to the freedom of the Netherlands from Spain. The Dutch seized the Portuguese trading posts in Asia and Africa, and in 1602 formed the Dutch East

India Company. Only in Brazil did Portuguese control of any large area continue.

During the sixteenth century, Spain was the dominant European power. Spanish *conquistadores* plundered the rich Aztec and Incan treasures in the new world, and barbarously took possession of a large amount of territory. Spanish treasure fleets plowed back and forth between Europe and the new world, pouring into Europe huge quantities of the precious metals, particularly silver from the rich veins in Mexico, Bolivia, and Peru. Some of the metal was captured by British sea raiders, such as Francis Drake, Thomas Cavendish, Humphrey Gilbert, and Walter Raleigh. Little gold was brought back in the early period, but later the placer mines in Brazil were discovered and exploited. During the four centuries after Columbus, more than fourteen billion ounces of silver and one billion of gold were produced. As a result of the fabulous increase in the precious metals, the commodity price level rose sharply in Europe. Index numbers of prices rose from about 25 in 1500 to about 140 in 1600.<sup>3</sup>

Besides the gold and silver from the Americas, came products which were entirely new to Europeans. Among the latter were such articles as cocoa, tobacco, maize, lima beans, potatoes, tapioca, and quinine. In exchange for these commodities, Europe shipped wheat, hardware, gunpowder, cloth, and cheap trinkets for trade with the natives. The Europeans introduced many plants and animals into the new world, and before long there were supplies of these to be exported to Europe. In the West Indies, the manufacture of rum, made from fermented sugar cane, became a major industry.

The Spanish Empire remained largely intact until the beginning of the nineteenth century. Long before the empire finally collapsed, however, Spanish influence began to wane, the decline being due in large measure to the failure of Spain to put commerce ahead of political exploitation. Colonial mismanagement, oppression, extravagance, and political intrigue eventually cost Spain her empire and her commanding position in

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<sup>3</sup> Carl Snyder, "The Problem of Monetary and Economic Stability," *Quarterly Journal of Economics*, February, 1935.

world affairs. Spanish culture, however, was thoroughly implanted in the new world, and continues strong today.

**Commercial Companies.**—An interesting development in the conduct of commerce, following the discovery of the new world, was the appearance of the commercial company. The risks of long voyages and the capital outlay involved were often greater than one individual could undertake. Several persons therefore banded themselves together in companies for the purpose of pooling their resources and sharing the gains, or losses. These commercial companies were chartered by the government and were usually very profitable. The wealth which accrued to the shareholders was considerable, so that the merchants grew rich. These companies were often given the exclusive right to trade with a particular area or colony, and were sometimes charged with the responsibility of actually governing and defending the colony.

Some of the commercial companies, such as the British East India Company organized in 1600 under Queen Elizabeth for trade with India, were even more powerful than the Hanseatic League. The British East India Company ruled India until the Sepoy rebellion in 1857.<sup>4</sup> It was believed necessary to give these companies such extensive privileges because they were assuming the risks of trading, and were providing the large amounts of capital required. The privileges were often grossly abused by the companies, the foreign natives being ruthlessly exploited. The most powerful of the commercial companies were those of Britain. Among these were the Levant Company, the Virginia Company, an African Company, a Russian Company, and the Hudsons Bay Company; the last is still in existence.

One of the most notorious of these early companies was the South Sea Company, whose activities became known as the South Sea Bubble. The company was organized early in the eighteenth century (1711) to exploit the resources of South America, which had been partially opened to English traders by the Treaty of Utrecht. The public, expecting rich returns,

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<sup>4</sup> Holland, Denmark, Prussia, and Scotland also established East India companies. Most important of these was the Dutch East India Company, organized in 1602 and dissolved in 1798.

scrambled to buy shares in the company. The managers of the company, elated by its popularity, offered the government a proposition wherein the company would take over the government debt on a 6% basis, which was lower than the rates prevailing in the market. The offer was accepted, and the managers then endeavored to induce the holders of National Stock to exchange this for shares in the South Sea Company. According to this arrangement the government would then be paying the company the 6% interest on the stock. The value of the company's shares given in exchange, however, was uncertain. The plan was successful and the company issued large numbers of its shares in exchange for government stock.

Shares in the company were bid up higher and higher, and shares formerly selling at £100 were sold at £1,300. Finally the public realized that the resources of South America were not unlimited, and that so many shares had been sold that, when the profits were divided around, each shareholder would not receive very much. The shares declined rapidly as everybody was eager to sell. The bubble burst, and the corruption was found to involve government officials.

**British Ascendancy and Colonial Policy.**—During the seventeenth and eighteenth centuries, commerce and war went hand in hand. The history of these years is to a large extent a contest of the nations for trade advantages, colonies, and imperial power. Commerce was regarded as the source of power, and colonies as the source of commerce. The Netherlands, which had succeeded Spain as the leading commercial nation, was forced in the latter part of the seventeenth century to capitulate to France and Britain. As a result of the Seven Years' War, which was ended in 1763 by the Treaty of Paris, England gained Canada and Nova Scotia from France, as well as several islands in the West Indies. England also retained her two forts controlling the Mediterranean—Gibraltar and Port Mahon on the island of Minorca. Britain was now the undisputed commercial leader.

The foreign colonies established by England were settlements made up of people who regarded the colony as their per-

manent home. On the other hand, according to the mercantilist philosophy then prevailing in Europe, colonies were considered as outlets for the sale of manufactures, and as areas from which the mother country could receive raw materials. Colonial commerce was, therefore, extensively regulated in the interests of the mother country. Navigation laws and commercial companies were established so as to prevent trade of the colonies from being diverted to other countries. The colonies were thus not free to trade where they wished and in the manner they wished, but were exploited for the home country. England pushed this policy too far with her thirteen colonies on the Atlantic coast, with the result that she lost these valuable possessions through colonial rebellion. The American Revolution caused England to modify her colonial policy with respect to other possessions.

In the same year that the American colonies declared their independence from England, Adam Smith published his celebrated *Wealth of Nations*, which vigorously refuted the mercantilist philosophy. He preached the doctrine of laissez-faire, and urged that the government leave trade unfettered to develop as it would. These doctrines of Adam Smith were widely accepted and very soon became the basis of governmental policy.

At the same time, there was beginning in England the Industrial Revolution. The Industrial Revolution completely changed the character of the goods entering into foreign commerce, with consequent profound effects upon the world's trade. The economies of large-scale production, made possible by the Industrial Revolution, led nations to specialize, and to abandon self-sufficiency even in the production of necessities. The result was that necessities rather than luxuries soon made up the greater part of the goods of foreign commerce. Trade expanded rapidly, and huge quantities of goods, no longer merely spices and laces, but food, iron, and machinery, were moved long distances.

England became rapidly industrialized, turning out large quantities of manufactured articles. The industrialists in England desired cheap food for the workers, and during the 1840's

the Corn Laws were repealed. This stimulated the importation of grain, and since the grain had to be paid for by exports, foreign commerce was further encouraged. The free trade policy of Great Britain which permitted industries to develop extensively, and the country's consequent dependence upon foreign sources for food and other necessities, have greatly changed the character of Britain's entire economic life, and have improved the standard of living. This policy has extended British commerce and been one of the main sources of British power.

Because of specialization and greatly increased production in all countries, the volume of world commerce has increased to an amazing degree during the past century and a half. In this development Great Britain has played the leading rôle, and has been the principal carrier of the world's trade. With her widespread colonial empire, industrialization and specialization at home, and a large fleet of ships, Great Britain is vitally dependent upon the flow of foreign commerce. Her naval policy has thus been an accompaniment of commercial expansion. British ships are found all over the world, wherever ships venture.<sup>5</sup>

The dominant position of Great Britain, however, has for some time been gradually weakening. The empire has been demanding, and receiving, more and more independence from the mother country. This decentralization has been furthered by the second World War, which showed outlying areas that they could not rely upon Great Britain for military protection.

History will decide the extent to which the war signaled the disintegration or transformation of the British Empire. The empire has in recent years been held together more by sentiment and economic ties than by political authority. There no longer is a place in the world's economic and political life for the traditional system of empires and paternalistic rule by absentee overlords. The war has given the final blow to what was left of the philosophy that colonies are for economic exploitation. The transformation of the empire, or its merger into a broader world system may be the trend of affairs.

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<sup>5</sup> British commerce is discussed further in Chapter 38.

## CHAPTER 3

### FOREIGN TRADE OF THE UNITED STATES

**Colonial Trade.**—Prior to the discovery of America, Europe had a well-developed trade with the countries of the East, as noted in the previous chapter. As a result of large European purchases there, Europe had been drained of great quantities of the precious metals sent out in payment. The silks, gems, spices, and perfumes of the East were of small bulk and easily transported, whereas the manufactured and other products which Europe could offer in exchange were more difficult to carry long distances. Therefore, the precious metals were called upon to make payment. Moreover, the virtual blocking of the established trade routes to the East by the activity of the Turks in Asia Minor in the fourteenth and fifteenth centuries interfered more greatly with European exports than with European imports. The net result was that the balance of trade was against Europe, and Europe lost bullion. The drain of bullion brought a declining price level in Europe, or a rise in the value of gold and silver, with depressing effects.<sup>1</sup> Increased production of commodities and the development of the towns also contributed to the demand for gold and silver and the rise in value.

Explorers that came to America were, therefore, interested in seeking new sources of gold and silver. The lands to the west were desired not so much for their fields, timber, and other resources as they were for the precious metals they were thought to contain. Exploration was to a large extent a quest for gold and silver, and it was the lure of these metals that attracted European adventurers. The newly discovered lands yielded

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<sup>1</sup> Carl Snyder, "Gold, the Arbiter of Destiny," *Proceedings of the Institute of Finance*, Occidental College, March, 1931.

these metals in extremely bountiful fashion. Little gold or silver, however, came in the early period from the territory which now comprises the United States. Silver came from the rich mines of Mexico, Peru, and Bolivia, and gold from Brazil. The region which constitutes the United States supplied Europe, however, with important quantities of crude raw materials and with several entirely new products.

Tobacco, previously unknown in Europe, was one of the principal articles of export from North America during the colonial period. It accounted for about one-fourth to one-half of all the exports sent out. The systematic cultivation of tobacco began early in the seventeenth century in Virginia, and by 1700 annual exports of tobacco amounted to about 29,000,000 pounds. By the time of the American Revolution these exports had increased to about 85,000,000 pounds with a value of about \$4,000,000.<sup>2</sup>

Another product exported during the early period was lumber. The iron industry in England had created a strong demand for charcoal, with the result that England's forests were rapidly being depleted. The abundant timber in the American colonies, therefore, provided England and other countries with a plentiful supply of lumber. Trees which could be used for masts for ships were especially in demand. The lumber came mostly from the northern colonies, since those in the south were more interested in tobacco.

With the principal materials for shipbuilding close at hand, the shipbuilding industry began to thrive in America early in the seventeenth century. Ships were built not only for domestic use but for sale to foreign countries, so that ships became an important article of export. It is said that at the time of the Revolution one-third of the ships under the British flag had been built in America. The preeminence of America in shipping and in seafaring occupations continued until the Civil War, when iron steamships replaced the old wooden sailing vessels. Other exports during the colonial period having to do with shipping were tar, pitch, rosin, and turpentine.

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<sup>2</sup> E. L. Bogart, *Economic History of the United States*, New York, Longmans, Green & Co., 1930.



The virgin country of North America yielded also large quantities of furs and skins which were easily exported to the European countries in exchange for much-needed manufactured goods and other articles. Fishing developed early in North America and provided the country with an important export. The fishing resources of the New England coast had been exploited by the British some time before regular settlements were established there. When settlements began to spring up, therefore, the fishing industry developed rapidly and became an important source of income to the New England colonies. Cod and mackerel were the principal fish exported.

While a few manufactured articles were exported, such as leather goods, the colonies were importers rather than exporters of finished products. Few industries had been developed, so that the colonies were dependent upon England and the continent for a large portion of their manufactured goods such as cloth, paper, iron, and iron products. The foreign trade of the colonies was principally with Great Britain and with the French and Spanish Indies.

The trade between the old world and the new, it will be seen, involved principally the giving of crude and raw materials or agricultural products in exchange for manufactured articles. In order to encourage the growth of domestic industries, most of the colonies had subsidies and tariffs, many of which, however, were directed not against foreign nations, but against competing colonies.

**American Trade and the Revolutionary War.**—England, like the other countries of Europe, regarded her colonies largely as a possession to be used for her own benefit—a source of raw materials and a market for her finished goods. In order to give effect to this policy, England placed various restrictions upon the trade of the colonies. She granted monopolies, levied duties, and endeavored to prevent the growth of industries in America. The Navigation Acts of 1651, 1660–1663 provided that no goods could be transported to or from British colonies except in British ships; they forbade the colonies from buying and selling directly in Europe and other foreign markets, and placed

other handicaps upon American trade and industry. Until the end of the Seven Years' War in 1763, however, the restrictions of Great Britain had not been taken very seriously in America. They were either not enforced or were to a large extent evaded, so that American trade and manufacturing forged ahead.

After the Seven Years' War, however, when the trade of the colonies, both domestic and foreign, was expanding rapidly, Great Britain undertook to enforce more rigidly her restrictive policies. The colonists protested vigorously and organized boycotts against British goods. Importations from Great Britain were finally reduced to such an extent that British mills had to close down. The conflict between Britain and the American colonies regarding commerce was one of the principal factors leading to the Revolutionary War and the independence of America.

During the Revolutionary War the foreign trade of the colonies was almost completely cut off. After the war, imports poured into America in such volume that many of the new industries, which had grown up during the war when foreign goods were unavailable, could not meet the foreign competition and found it necessary to shut down. Great Britain, moreover, enacted various laws which injured the American export trade. She practically excluded American ships from the West Indies, and insisted that exports to Great Britain could come in American ships only when the exports came from the same state in which the ship was owned. The export trade of the United States thus was not booming, nor was this country having much success in consummating commercial treaties with the various European governments.

Under the Articles of Confederation, Congress was powerless to enact retaliatory measures or to undertake to regulate commerce. The different states, therefore, adopted their own tariffs and other measures, which in many instances were directed at each other, as in the colonial days. This situation was remedied when the Constitution, which went into effect in 1789, gave Congress authority "to regulate commerce with foreign nations" and to levy duties. These powers were taken from the states by the Constitution and lodged with the federal govern-

ment. They may not be exercised by the states except with the consent of Congress.

**Trade During Napoleonic Wars.**—Changed conditions in Europe, principally the outbreak of the French Revolution in 1789 and the Napoleonic wars soon thereafter, led to interesting and important developments in America. The effect upon this country's shipping and foreign trade was particularly noteworthy. The United States remained neutral in the long struggle between France and Great Britain, to the great displeasure of France which had aided American independence. While Europe was occupied with wars, and was neglecting foreign commerce, the foreign trade of the United States grew by leaps and bounds. The belligerent countries were in great need of American commodities, particularly food products such as wheat, corn, and meat, so that exports from this country were large. Wool, cotton, and other raw materials were also in great demand. American agriculture boomed as the prices of these articles rose higher and higher. Land values rose and new land was cleared for cultivation. Exports of cotton, largely as a result of the invention of the cotton gin, increased from 200,000 pounds in 1791 to over 50,000,000 pounds in 1804.

French shipping virtually disappeared during the war. British shipping was concerned primarily with the prosecution of the war, so that American ships were enabled to do a very large amount of the world's carrying trade, particularly that formerly done by France and her allies. Much of the trade between Latin America, the West Indies, and Europe was conducted by way of the United States, where new papers were taken out, so as to remove some of the risks of the trade becoming the prey of British ships. In the year 1801 more than half of American exports were reexports.<sup>3</sup> American ships also carried goods from the Far East to Europe.

Due principally to the stimulus of the Napoleonic wars, the tonnage of American ships on the high seas increased six-fold in the fifteen years following the adoption of the Constitution.

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<sup>3</sup> Bogart, *op. cit.*

Earnings of American ships during this period were accordingly large.

The situation changed suddenly, and beginning about 1804 American foreign trade experienced an about-face. Both France and Great Britain had become jealous and uneasy over the expanding trade of the United States, a neutral. While the European nations fought, the United States was running off with the prize. These countries consequently enacted measures aimed to restrict the prosperous American trade. In 1804 England declared a blockade of certain French ports and made any vessel trading with these ports subject to capture. The blockade was extended until in 1807 it included all the ports of France, her colonies, and allies. Neutral vessels, by these Orders in Council, were forbidden to trade with any country under Napoleon's control. The territory involved included all Europe except Turkey and Scandinavia.

In 1806 and 1807, Napoleon for his part declared the continent entirely closed to British goods, and that any ship trading with Great Britain or her colonies, or that obeyed the British orders, was subject to capture. Thus any neutral vessel that touched at a British port was likely to be seized by France, and any such vessel that did not touch there was likely to be seized by Great Britain. If American ships traded with France or her allies they were subject to British capture, whereas if they traded with Britain or her allies they were subject to French capture. There was little territory left. As a matter of fact, there was a great deal of illicit trade as a result of corruption on the part of French, British, and other persons. These restrictive measures were aimed particularly at America. They succeeded in practically ruining American trade, so that about 1806 the rapid growth of American commerce came to an end.

The long-standing friction between the United States and Great Britain was intensified by the British practice of stopping American ships and taking off sailors that Great Britain claimed were British and that were needed in the war. Many British seamen had become naturalized Americans, and since it was not always easy to tell an American from a Britisher a good many American citizens were impressed by the British. America ob-

jected strenuously to this practice, and feeling ran high. Since America had almost no navy, she endeavored to retaliate by the Embargo Act of 1807 which prohibited American vessels from leaving America for foreign ports. The purpose of this Act was to starve Europe into giving America better treatment and to prevent ships from being captured. The effect on America, however, was disastrous. Consequently, in 1809 the Non-Intercourse Act was substituted. This permitted trade with all countries except France and Great Britain. Finally, in 1812, the United States took the bold step of declaring war on Great Britain, even though sentiment in this country was strongly divided on the matter.

**Trade After the War of 1812.**—With the defeat of Napoleon and the opening of Europe to British trade in 1813 and 1814, most of the causes of the trouble between the United States and Great Britain were automatically removed. By the Treaty of Ghent, in December, 1814, peace between the two English-speaking nations was reestablished. Contrary to expectations, the United States had been successful in the contest on the sea, but not in that on land.

When the war was over, the foreign trade of the United States expanded greatly, as practically always is the case following a war. Demands pent up during the war were let loose, and shipping was resumed. An enormous cotton crop was harvested in 1815, which helped to swell exports. Currency inflation and reckless speculation took place, and resulted in a high level of commodity prices, in large profits and so-called prosperity. Shipping enjoyed its share of the prevalent prosperity.

Importations of goods from abroad were tremendous in 1814, 1815, and 1816. Foreign goods literally flooded the country, and although this damaged American manufactures and brought an end to the few months of special activity that manufacturers had enjoyed immediately following the war, the popular view at the time was that the huge imports represented great business development and prosperity.

The demand for protection against the inundation of foreign goods was strong when the boom came to an end in 1815.

Foreign nations had begun to enact commercial restrictions which handicapped American trade, so that sentiment developed in America that this country should also apply restrictions to foreign goods. In 1815 Great Britain raised the duty upon grain imports so high that American grain was almost completely excluded from the British market. Congress, therefore, in 1816 enacted a protective tariff, which imposed a duty of about 20% upon foreign textiles, and duties on other goods.

The boom ended in 1815, and from 1816 until about 1821 the United States was in a depression which became especially severe in 1819. The heavy influx of foreign goods was checked by the depression, and also by the new tariff adopted in 1816. Furthermore, lower prices of commodities reduced the values of the goods imported. Imports accordingly fell from about \$147,000,000 in 1816 to about \$74,000,000 in 1820. The sharp decline which foreign trade suffered was the beginning of a period of declining or stationary foreign trade for the United States lasting until about 1830.

The large volume of trade from 1789 until 1818 had been based chiefly upon the wars and troubles of Europe. As Europe returned to peaceful pursuits, American goods and ships were in less demand. The period following the Napoleonic wars was marked by general economic troubles throughout the world and by the enactment by most countries of tariffs and other restrictions upon trade, a situation somewhat similar to that following the first World War. With foreign trade no longer prospering, the United States turned its attention to domestic affairs and to the development of its own industries and vast resources. The United States now looked more to the undeveloped west than to the east.

After 1830 and until about 1850 the foreign trade of the United States was again growing, but growing rather slowly. Imports fluctuated more widely than did exports. Foreign trade, especially the import trade, was active in 1836 during the speculative boom which collapsed in 1837 and which centered around land. Foreign trade declined after the boom.

About 1850 both imports and exports began to expand rapidly and continued to do so until the outbreak of the Civil War.

Most of the increase in exports during this period was accounted for by the development of the cotton industry in the south. With cotton constituting more than half of the country's exports, about two-thirds of all exports came from the south. New Orleans ranked as a port next to New York. The north was concerning itself more with manufacturing, while the south was enjoying agricultural expansion.

**Trade from 1860 to 1914.**—Foreign trade received a severe setback during the Civil War, as can be seen in the accompanying chart (Figure 1) which shows America's foreign trade since 1850. The trade of the southern states was particularly hard hit and came almost to a standstill. In 1861 the federal government proclaimed a blockade of all ports of the southern states. Although the blockade could not be enforced immediately, soon the federal government had either captured or effectively closed all the principal southern ports. Blockade runners, especially British vessels, managed to land goods and pick up cargoes, although the business was an extremely hazardous one. Cotton exports declined from about \$200,000,000 in 1860 to about \$4,000,000 in 1863. It was said that by 1864 a pound of cotton could be bought for 4 cents in Charleston while in Liverpool its cost was \$2.50. The closing of the market for the south's great product, cotton, was a serious blow to the south, and one of the deciding factors in the war.

After the war, foreign markets again received attention. The United States went through eight years of intense business activity and boom culminating in 1873. During this period foreign trade, especially imports, enjoyed phenomenal increases. Total foreign trade increased from \$405,000,000 in 1865 to \$1,164,000,000 in 1873.

During the post-Civil War period the opening of the agricultural lands in the middle west had important effects upon foreign trade. Even during the time the war was being fought, the north developed its agricultural resources, and introduced improved machinery which greatly increased the volume of agricultural output, particularly that of grain. The country's population moved westward into the Mississippi valley dur-

## UNITED STATES FOREIGN TRADE

ANNUALLY

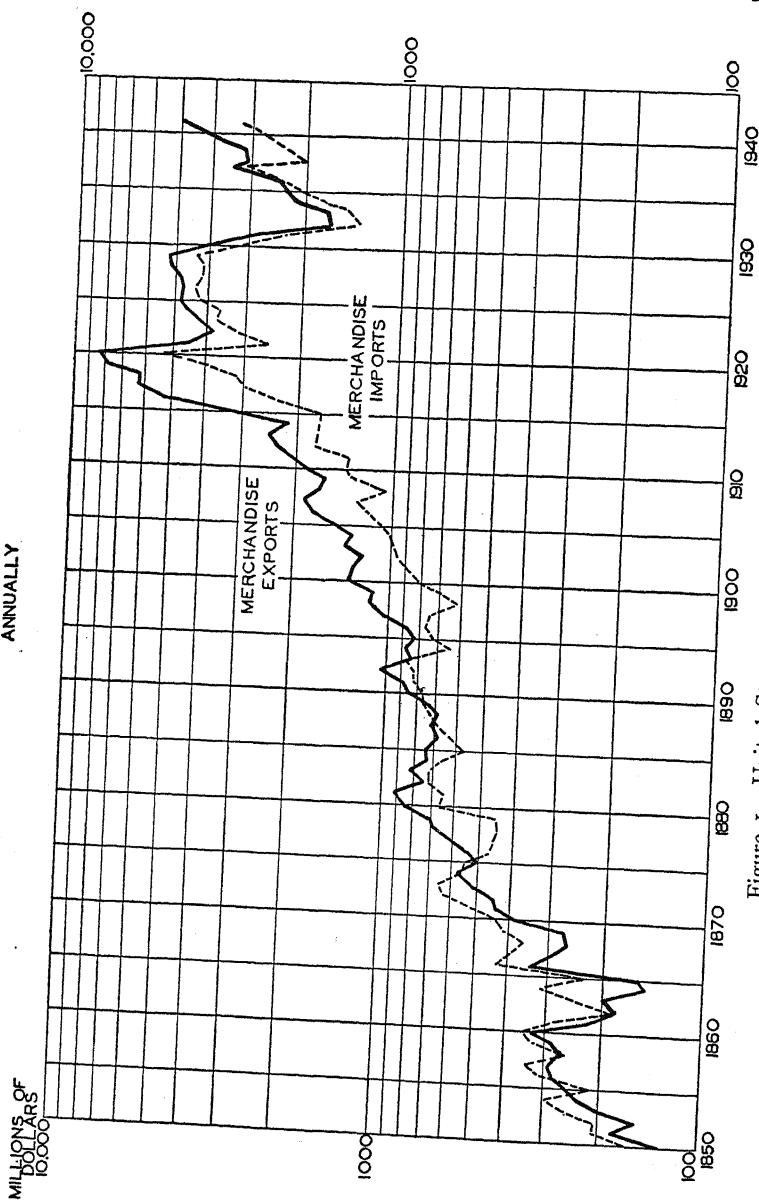


Figure 1. United States Foreign Trade Since 1850



ing and after the war and opened up extensive tracts of land. Immigration from Europe was large, and many of the immigrants settled in the grain-producing states where land was plentiful. Railroads were extended rapidly, too rapidly, in fact, from the profit standpoint, and were pushed into new and undeveloped territory. Active railroad construction meant cheap transportation from the agricultural sections to the seaboard, whence products could move easily to foreign countries.

As a result of these developments, agricultural products of the middle west began about 1870 to constitute an increasingly important element in the nation's total exports. Between 1870 and 1880 total exports more than doubled, due in large part to increases in exports of grain and breadstuffs.

The variety of goods exported also increased during the latter part of the century, so that whereas in 1860 the first six items of exports accounted for over 90% of all exports, by 1900 the first six items accounted for only about 65% of all exports.

One of the effects of the Civil War was the almost complete disappearance of American ships from the high seas. During the war most of the ships were destroyed by Confederate cruisers, were converted into war vessels, or were sold to foreigners. After the war the United States would not permit vessels that had been sold to foreigners to fly again the American flag. Another blow to the merchant marine was the high duties upon shipbuilding materials, iron, steel, copper, lumber, and cordage. American shipbuilders were thus unable to compete successfully with foreigners. One of the fundamental causes, however, for the decay of the American merchant marine was the passing of the old wooden ship and the picturesque sailing vessel. In the construction of such ships the United States was especially favored. American seamen also knew how to handle these ships. The United States was not so well prepared to build and operate iron and steel vessels propelled by steam as was England and other foreign countries.

When the first World War broke out in 1914 the United States found herself almost completely dependent upon ships of other nations. As these ships were withdrawn or used for war

purposes, American trade was handicapped. American troops were carried to Europe in ships of Great Britain, France, and Italy, and in the seized ships of Germany. Prior to the second World War the United States endeavored to build up American shipping through subsidies of various kinds. In this effort she attained moderate success, although the tonnage of available ships was still inadequate for the huge task. This program is discussed in a subsequent chapter.

The year 1874 was noteworthy in that the balance of merchandise trade of the country shifted that year from an excess of merchandise imports, which had existed more or less regularly as far back as records go, to an excess of merchandise exports. Since 1874 the United States has, with two exceptions (1888 and 1889), continuously had an annual excess of merchandise exports.

The explanation of this shift to a so-called favorable balance has to do principally with the development of the country by foreign capital. New capital had come to America from Europe in large amounts, and accordingly tended to increase imports. Prior to about 1874, the influx of new capital, together with shipping services rendered by the United States (so-called invisible exports) and other transactions involving payments to this country, were in excess of interest payments which this country had to make abroad and other items involving payments by the United States.<sup>4</sup> In 1873 the United States experienced a severe financial panic, followed by prolonged depression. The boom preceding the panic had centered around speculation in railroad securities accompanying rapid railroad expansion, financed to a considerable extent by European capital. With the panic, activity slowed down. After 1874 interest payments due by the United States were larger than the new capital received, so that exports tended to exceed imports.

About 1900 another period of rapid expansion of America's foreign trade began. It continued to the beginning of the first World War when still greater expansion took place. The stim-

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<sup>4</sup> The theoretical aspects of this question are discussed in Chapter 7 on the Balance of International Payments.

ulus to trade following 1900 was the extensive development of large-scale manufacturing industries and the marked improvement in transportation facilities on both land and sea. The United States, by this time, had become a great industrial nation with huge factories pouring out quantities of goods. Although the United States was an industrial nation, it was, and still is, also an agricultural nation. The change in the character of the foreign trade of the United States during the country's history can be seen in Table 1, on page 50.

**Trade from 1914 to 1929.**—When war broke out in 1914, the foreign trade of practically the entire world became thoroughly disorganized. Shipping was disrupted, and much of it became the prey of enemy vessels. Peacetime cargoes gave way to war-time necessities. The productive equipment of all nations, particularly of the belligerents, was directed to war purposes. Products of the neutral nations were in great demand, and exports from the United States rose abruptly from \$2,400,000,000 in 1914 to \$6,300,000,000 in 1917. Imports into the United States declined slightly during the first two years of the war, but in 1916 imports were larger than ever before. The increase in imports, as would be supposed, was relatively less than that of exports, inasmuch as European production was handicapped by war. Part of the increase of both exports and imports was due to the high level of commodity prices that prevailed, rather than to greater quantities shipped.

After the United States joined the war in 1917, this country continued to supply Europe with large quantities of goods of all kinds, so that exports remained large. The principal exports were foodstuffs, iron and steel, and textiles. A country cannot fight and produce as usual, so that in 1918 exports were a little less than in 1917, even though commodity prices were higher. The large exports of the United States during the war period were financed to a great extent by loans, and changed this country from a debtor nation to a creditor. Many of the loans, however, were uncollectible.

The greatest increase in America's foreign trade came in the two years following the war, 1919 and 1920. The tremendous

increase was caused by the release of demands pent up during the war, by the restoration of ships to their former trade routes, and by the further inflation of commodity prices which made part of the increase more apparent than real.

During the war, ships had been busy carrying troops and necessary war supplies. Upon the signing of the Armistice, the submarine danger was removed and vessels were free to go where they chose. Neutral nations, made prosperous by the war, and nations formerly belligerent thereupon were enabled to purchase many articles formerly unavailable. In 1920 exports and imports of the United States both reached the highest points in dollar values ever reached before or since. Exports mounted to \$8,228,000,000 and imports to \$5,278,000,000. The continuation of inflation by practically all countries, resulting in soaring commodity prices, coupled with the seemingly unlimited demand for certain commodities, brought about great prosperity and boom, prosperity of an unstable and spurious type it is true, but in which foreign trade shared generously.

Foreign countries, particularly those of Latin America, bought heavily in the United States immediately after the war. The orders came pouring in so fast that American factories were unable to meet the demands. The American manufacturers accordingly began to scale down the orders before filling them. Foreign purchasers, finding their orders reduced, countered by ordering more than they really wanted. Price was of little importance since the goods could be sold at almost any price. When the bubble burst in 1920, American producers attempted to fill the orders in full, and foreign purchasers replied by wholesale cancellations of orders. The losses on both sides were severe. Sellers who permitted cancellations fared better than those who attempted to enforce the sale.

The depression of 1920-1921, disastrous to so many undertakings, was especially disastrous to foreign trade. Both exports and imports of the United States declined in 1922 to less than half their 1920 high points. As the world recovered from the depression and the effects of war, the world's production became organized upon a peacetime basis and foreign trade resumed its upward climb. The United States found then that

it had to meet the competition of European nations, competition which had been almost wholly absent since 1914. Although the United States lost some of the newly gained markets, chiefly those in Latin America and the Orient, to the countries which originally served them, the United States came out of the war a powerful, if not the most powerful, nation in the field of international commerce and finance.

**Trade Since 1929.**—The prosperity and boom of the twenties, which ended abruptly in 1929, were reflected in active foreign commerce. By 1929 the trade of the United States had risen so that exports amounted to \$5,241,000,000 and imports to \$4,400,000,000.<sup>5</sup> The depression which began in that year brought with it a much more severe decline in the country's foreign commerce than that of 1920–1921. In the year 1932 exports amounted to only \$1,612,000,000 and imports to only \$1,323,000,000. Exports were thus only about 29% of the 1929 figure and imports only about 30%. This decline was greater than that of other leading nations, for which the 1932 trade was, on the average, about 38% of the 1929 trade. The accompanying chart (Figure 2) shows the value of United States foreign trade since 1928, the decline and subsequent recovery. Inasmuch as the commodity price level fell by about one-third, the decline in quantities shipped was not as great as that of the values of the goods. The effect of the drastic decline of foreign trade upon the industries of the United States and upon the agricultural population, which depended upon the foreign market as an outlet for much of its production, was severe.

The causes of the decline in foreign trade had to do with the disruption of economic conditions all over the world, accompanying the unprecedented and worldwide depression. The decline was also a direct outgrowth of the high tariffs adopted by the United States and other nations, and of the many other restrictive devices put into force. The United States, a large creditor on capital account, made difficult the payment of in-

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<sup>5</sup> Unless otherwise indicated, reference is made throughout only to the merchandise trade, and not to invisible items.

## UNITED STATES FOREIGN TRADE

MERCHANDISE EXPORTS AND IMPORTS

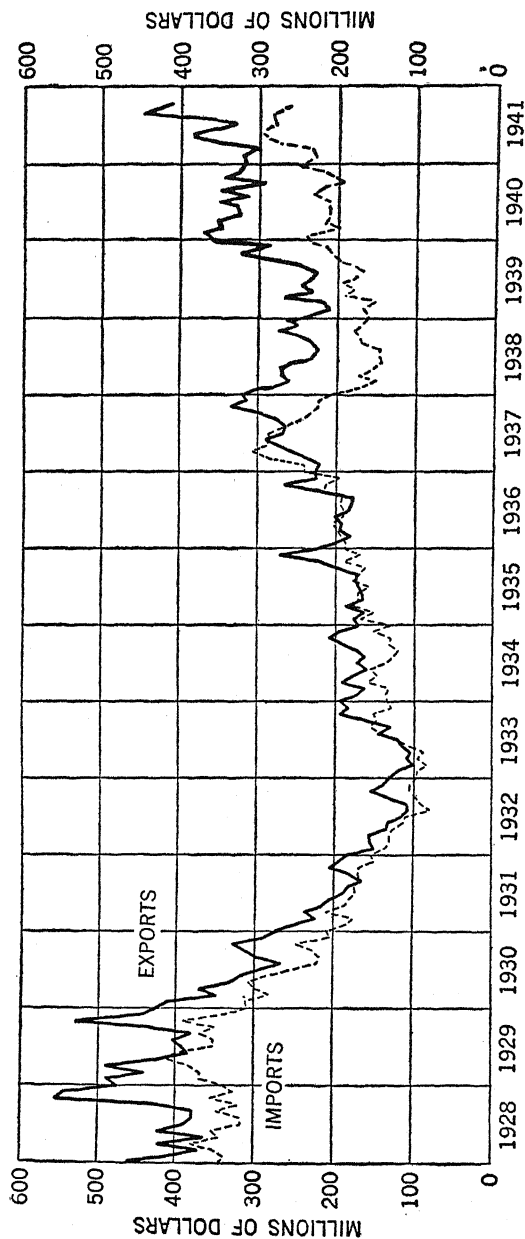


Figure 2. United States Foreign Trade Since 1928

terest to it by its tariff policy, one of the causes of the huge gold importations, particularly during the twenties. The large merchandise exports of the United States during the twenties were financed to a considerable extent by loans, rather than being paid for by imports. Foreign bonds were sold in the United States and the proceeds which were made available to foreigners were used to buy American goods. The export trade was thus sustained by loans, particularly by the numerous foreign bond issues floated in the United States and sold to an American public uninformed in regard to foreign investments. Many of these bonds were unsound and should never have been sold. Defaults grew with the depression, and the losses to the holders were large.

The growth of economic nationalism throughout the world and the desire to be self-sufficient were partly responsible for the many obstacles to the free flow of trade. Currency disorders and resultant foreign exchange controls interfered with the purchase and sale of drafts. Licenses, embargoes, quotas, and the many other types of restrictions that were put into force all but stifled foreign trade. The United States Department of State, beginning in 1934, negotiated trade treaties with many foreign countries for the purpose of reducing tariffs and thereby encouraging the flow of trade. These were helpful, but did not solve the problem.

As depression gave way to recovery, foreign trade, beginning in 1933, regained much of the ground lost. All over the world trade again increased, but the improvement as far as Europe was concerned was cut short by the outbreak of war in 1939. The foreign trade of the United States, however, was expanded by the war, and in 1941 exports amounted to \$5,146,000,000 and imports to \$3,345,000,000. Imports from Latin America were especially stimulated by the war, although the shipping shortage and submarine activity were a severe handicap to foreign trade.

**Character and Direction of Trade.**—The United States has gradually changed from an exporter of raw and crude materials, and an importer of manufactured articles, to an importer

TABLE I. CHANGES IN CHARACTER OF UNITED STATES  
FOREIGN MERCHANDISE TRADE  
(Per cent of total)

	IMPORTS				DOMESTIC EXPORTS			
	1820a	1860a	1929b	1939b	1820a	1860a	1929b	1939b
1. Crude materials. . . .	4%	11%	35%	33%	61%	68%	22%	17%
2. Foodstuffs in crude condition. . . . .	11	13	12	13	9	4	5	4
3. Foodstuffs wholly or partly manufactured. . . . .	20	17	10	14	20	12	9	6
4. Semi-manufactures. . . .	8	10	20	21	9	4	14	20
5. Finished manufactures. . . . .	57	49	23	19	6	11	49	53
Total trade (millions of dollars) . . . . .	\$74	\$354	\$4,400	\$2,318	\$70c	\$334c	\$5,241c	\$3,178c

a Year ending June 30.

b Calendar year.

c Totals for exports include domestic exports and re-exports.

(Source: U. S. Department of Commerce, *Foreign Commerce and Navigation of the United States.*)

TABLE 2. PRINCIPAL EXPORTS OF THE UNITED STATES, 1940

Aircraft and parts a. . . . .	\$311,757,000	Iron and steel bars, rods. \$	64,317,000
Automobiles and parts. . . .	254,308,000	Firearms and ammunition	64,164,000
Metal-working machinery	246,516,000	Iron and steel tubular products . . . . .	48,398,000
Unmanufactured cotton. . .	213,662,000	Iron and steel scrap. . . .	47,097,000
Electrical machinery . . .	116,708,000	Tin plate . . . . .	44,375,000
Steel ingots, blooms, slabs	98,543,000	Leaf tobacco . . . . .	43,632,000
Iron and steel plates, sheets . . . . .	97,609,000	Merchant vessels . . . . .	40,799,000
Lubricating oil . . . . .	94,465,000	Cotton cloth . . . . .	37,910,000
Coal and coke. . . . .	87,068,000	Gas oil and fuel oil. . . .	34,667,000
Refined copper . . . . .	81,841,000	Structural iron and steel	33,892,000
Agricultural machinery. . .	76,879,000	Construction-conveying machinery . . . . .	31,370,000
Crude petroleum . . . . .	67,845,000	Wood pulp . . . . .	29,746,000
Gasoline . . . . .	64,859,000		

(Source: U. S. Department of Commerce)

a Airport exports in 1939 amounted to \$117,806,000.



of raw materials and an exporter of finished products. This shift in the character of the trade reflects the industrial development of the country, and may be seen from the figures in Table 1. Attention is called particularly to groups 1 and 5.

The principal commodities exported from the United States are shown in order of value in Table 2.

Most of the crude materials and foodstuffs, especially cotton and grain, ordinarily go to Europe. As a consequence of the large agricultural exports, the exports to Europe have usually shown a marked seasonal expansion in the fall and early winter. Europe also takes large quantities of American manufactures and semi-manufactures. Inasmuch as Asia takes a considerable amount of American farm products—cotton and tobacco—exports to Asia also have exhibited a seasonal increase in the fall.

The principal commodities imported into the United States are shown in order of value in Table 3.

TABLE 3. PRINCIPAL IMPORTS OF THE UNITED STATES, 1940

Crude rubber <sup>a</sup> .....	\$318,469,000	Diamonds .....	\$ 44,625,000
Tin bars, blocks, pigs <sup>a</sup> ..	128,294,000	Nickel and alloys .....	41,551,000
Coffee .....	126,808,000	Unmanufactured tobacco	46,722,000
Raw silk .....	124,997,000	Crude petroleum .....	32,211,000
Standard newsprint paper	124,667,000	Cocoa beans .....	32,141,000
Cane sugar .....	113,253,000	Bananas .....	29,094,000
Unmanufactured wool ..	84,604,000	Fish .....	29,074,000
Undressed and dressed furs .....	75,998,000	Gas oil and fuel oil....	28,187,000
Wood pulp .....	60,194,000	Sawed boards and other lumber .....	23,684,000
Copper ore, concentrates.	59,621,000	Tea .....	22,689,000
Raw hides, skins.....	50,188,000	Tung oil .....	20,274,000
Burlaps .....	45,476,000	Manganese ore .....	18,399,000
Distilled liquors .....	44,729,000		

(Source: U. S. Department of Commerce)

<sup>a</sup> A large portion of these imports was the result of building a stockpile. In 1939 rubber imports amounted to \$178,054,000, and tin imports to \$70,591,000.

Imports do not show the pronounced seasonal movements that exports do, but tend to be largest in the early part of the year. The leading foreign market for American exports is the United Kingdom, while the principal source of American imports is Canada. Table 4 shows the principal countries receiving American exports.

TABLE 4. DESTINATION OF UNITED STATES EXPORTS, 1940

United Kingdom .....	\$1,009,623,000	Venezuela .....	\$ 69,212,000
Canada .....	714,518,000	British India .....	68,428,000
France .....	252,455,000	Netherlands Indies ..	53,781,000
Japan .....	227,204,000	Colombia .....	51,691,000
Brazil .....	110,588,000	Italy .....	51,473,000
Argentina .....	106,877,000	Chile .....	43,428,000
British South Africa ..	105,928,000	Sweden .....	38,558,000
Mexico .....	96,941,000	Netherlands .....	34,023,000
Philippines .....	93,335,000	Spain .....	27,042,000
Soviet Russia .....	86,943,000	Belgium .....	24,977,000
Cuba .....	84,694,000	Finland .....	24,367,000
China .....	77,956,000	Peru .....	23,123,000
Australia .....	75,455,000		

(Source: U. S. Department of Commerce)

Countries from which American purchases most heavily are shown in Table 5.

TABLE 5. SOURCES OF UNITED STATES IMPORTS, 1940

Canada .....	\$400,562,000	British South Africa....	\$ 53,531,000
British Malaya .....	268,448,000	Colombia .....	47,462,000
Netherlands Indies .....	167,650,000	Venezuela .....	41,187,000
Japan .....	156,933,000	France .....	38,827,000
United Kingdom .....	135,691,000	Ceylon .....	30,378,000
Cuba .....	107,330,000	Belgium .....	29,513,000
Brazil .....	104,786,000	Switzerland .....	25,237,000
British India .....	101,099,000	Italy .....	25,177,000
Philippines .....	89,632,000	British West Africa....	24,855,000
China .....	87,493,000	Australia .....	24,286,000
Argentina .....	80,571,000	Soviet Russia .....	22,274,000
Mexico .....	62,503,000	Belgian Congo .....	19,277,000
Chile .....	56,970,000		

(Source: U. S. Department of Commerce)

Asia and Latin America are the principal sources of American imported crude materials and tropical foodstuffs. Nearly half of America's total foreign trade prior to the war was carried on with only four countries—Canada, Great Britain, France, and Japan.

Rubber, which ranks first on the list of imports, has come largely from the Malay peninsula and the Dutch East Indies. Sugar, in peacetime, is imported from Cuba and the Philippines. Coffee comes principally from Brazil, Colombia, Guatemala,

Salvador, and Costa Rica. Raw silk comes largely from Japan and China; petroleum from Mexico, Venezuela, and Colombia; copper from Chile, Canada, Mexico, and Peru; and hides from Argentina, Uruguay, Canada, and Brazil.

Table 6 is a summary of the total foreign commerce of the United States since 1800. Figures before 1821 are not reliable, inasmuch as prior to that time imports that were not dutiable were not recorded, and such imports as were subject to a specific duty were recorded only by quantities, not values. In 1835, the Treasury Department compiled figures for the early period, basing many of the figures upon estimates.

TABLE 6. FOREIGN COMMERCE OF THE UNITED STATES

	Exports	Imports	Total
1800*.....	\$ 71,000,000	\$ 91,300,000	\$ 162,300,000
1810.....	66,800,000	85,400,000	152,200,000
1820.....	69,700,000	74,500,000	144,200,000
1830.....	71,700,000	62,700,000	134,400,000
1840.....	123,700,000	98,300,000	222,000,000
1850.....	144,400,000	172,500,000	316,900,000
1860.....	333,600,000	353,600,000	687,200,000
1870.....	403,600,000	461,000,000	864,600,000
1880.....	889,700,000	697,000,000	1,586,700,000
1890.....	857,500,000	823,400,000	1,680,900,000
1900.....	1,477,900,000	829,100,000	2,307,000,000
1910.....	1,866,300,000	1,562,900,000	3,429,200,000
1920.....	8,228,000,000	5,278,500,000	13,506,500,000
1929.....	5,241,000,000	4,400,000,000	9,641,000,000
1930.....	3,843,200,000	3,060,900,000	6,904,100,000
1931.....	2,424,000,000	2,090,000,000	4,514,000,000
1932.....	1,612,000,000	1,323,000,000	2,935,000,000
1933.....	1,675,000,000	1,450,000,000	3,125,000,000
1934.....	2,133,000,000	1,655,000,000	3,788,000,000
1935.....	2,283,000,000	2,047,000,000	4,330,000,000
1936.....	2,415,000,000	2,420,000,000	4,835,000,000
1937.....	3,345,000,000	3,084,000,000	6,429,000,000
1938.....	3,094,000,000	1,960,000,000	5,055,000,000
1939.....	3,178,000,000	2,318,000,000	5,496,000,000
1940.....	4,022,000,000	2,625,000,000	6,647,000,000
1941.....	5,146,000,000	3,345,000,000	8,491,000,000

\* Fiscal years prior to 1870.

(Source: U. S. Department of Commerce)

## CHAPTER 4

# RAW MATERIALS IN THE INTERNATIONAL ECONOMY

**Interdependence in Raw Materials.**—Modern industry requires a great variety of resources and materials, and these are scattered very unevenly throughout the world. From this condition grow a host of problems, both economic and political. Valuable minerals essential to industry are located in generous amounts in some countries while they scarcely exist at all in others. Rich agricultural lands abound in certain areas while in others the land is largely barren. Climatic conditions may be favorable or unfavorable, and affect such resources as forests, grains, and animal life. It is this uneven distribution of resources which makes nations, to a greater or less extent, dependent on one another, and which is one of the basic reasons for trade, and also for much economic rivalry.

No nation is adequately supplied with all the materials required by modern technology and a highly industrialized society. The United States surpasses other countries with respect to diversified resources, but the United States, as the war emphasizes, lacks completely or almost completely such articles as rubber, manganese, nickel, chromite, tungsten, antimony, and tin. Most small countries lack a great many important resources, and are therefore especially dependent upon other countries in their economic life. The development of synthetic materials does not solve the problem, since most synthetic products are either more expensive or less desirable than the natural products.

Countries are not only interdependent in securing essential materials which they lack, but are also interdependent in selling those materials which they possess. Only as a nation can sell to other nations its raw materials, manufactures, or services can

it obtain from abroad those articles and services which it requires. In many instances, particularly during the early stages of industrial development, countries depend largely upon the export of raw materials to buy other resources or articles needed. This was the case in the United States during the nineteenth century.

The uneven distribution of basic resources has been a prominent factor in determining the industrial development of nations and also the direction of world politics and history. Nations have continually struggled with one another for possession of resources which were deemed essential to national existence or which would add to the nation's power. It is easy to over-emphasize raw materials as a cause of war, yet so long as nations desire to have political control over areas containing important resources, conflicts of interest develop. War for economic reasons is practically always very unprofitable, viewing the cost and results purely in terms of money and economic gain or loss. Raw materials, as noted below, are usually available in the world market to any purchaser, but nations like to have political control over the areas producing such materials. In the desire to build empires, raw materials have provided a useful objective. Nations have been willing to entail great costs and engage in expensive military operations to attain these ends. Were trade free and unrestricted, and were the world organized upon an enlightened basis, both politically and economically, nations would have little reason to seek political control over other areas.

The penetration by a highly industrialized power of an industrially undeveloped area, whether peacefully or by means of force, represents in part the quest for raw materials and markets, and for the power which their possession is believed to bring. Capital and traders enter these undeveloped areas because of opportunities for greater profits, and are frequently encouraged and given military and financial assistance by their home governments.

The rapid industrial development of certain nations and the slow development of others have been due in part to the possession or lack of vital resources. The early start which England

obtained in industry was in no small measure due to the excellent British coal and iron deposits. Lack of coal and iron has been a handicap to the industrial advancement of such countries as Argentina and Norway.

From the economic standpoint the mere physical existence of a certain raw material is not necessarily of any great significance. Only as the material is exploitable and accessible to markets where it is wanted does it enter the international economic sphere. Raw materials in remote and inaccessible parts of the world, or where political conditions make them unavailable, or where the demand for various reasons does not call them into use, are not part of the immediate picture. Improved technology, transportation, or changes in demand may, however, alter the situation at any time.

**Political Control over Raw Materials.**<sup>1</sup>—During the period preceding the outbreak of war in 1939, much was said concerning rivalry over raw materials, and their relation to war and peace. It was sometimes argued that the main cause of war lay in the uneven distribution of the important industrial raw materials. It was held that nations which possessed a wide variety of essential raw materials—the so-called “haves”—tended to be peace-loving, while those countries which were seriously lacking in such materials—the “have-nots”—tended to be war-minded. War was regarded as inevitable and was even condoned since the “haves” were not willing to hand over rich territory to the “have-nots.” History was said to be largely a record of contest for resources and markets. The prestige of this theory was enhanced by dictators and their spokesmen, who espoused the above formula as the cause of the world crisis. They informed the world that their countries must have more territory and colonies as a source of vital raw materials, and as an outlet for an excessive number of people and products. Regardless of the fallacies in this contention, the keen rivalry for political control over raw materials cannot be denied.

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<sup>1</sup> In connection with this section see Sir Norman Angell, *Raw Materials, Population Pressure, and War*, Boston and New York, World Peace Foundation, 1936; and Eugene Staley, *Raw Materials in Peace and War*, New York, Council on Foreign Relations, 1937.

The above line of reasoning has had many adherents and raises several important questions. What hindrances have there been, if any, to the securing of necessary raw materials? In what ways, if any, does political control over a territory aid in obtaining raw materials therefrom? Would a redistribution of territory among the leading nations with the end of securing, as far as possible, national self-sufficiency, reduce friction and promote peace, economic well-being, and full use of resources? What was the real basis of the trend during the nineteen twenties and thirties toward national self-sufficiency?

Prior to 1939 there were nearly three score independent sovereign nations in the world. With the existing highly uneven distribution of raw materials, it would be obviously impossible to divide the earth so that each of these nations could be even approximately self-sufficient, except perhaps on a primitive agricultural basis. To adjust boundaries in such a way that sixty nations could be self-contained, each having within its borders the essential raw materials, is clearly out of the question. Even if this aim of self-sufficiency could somehow be achieved, each nation would be poorer than under a regime of international specialization and trade. To secure a maximum of goods and services for the peoples of the world it is necessary that there be a maximum rather than a minimum of international specialization and division of labor, a maximum rather than a minimum of trade and interdependence.

Why, then, has there been such extensive rivalry over resources and strenuous efforts toward self-sufficiency? Is it because nations are unable to secure on reasonable terms raw materials from regions which they do not politically control? According to popular discussion this would seem to have been the case, but a little scrutiny reveals that during the period of greatest rivalry, raw materials were available to all comers on approximately equal terms. Raw materials were freely available to all nations and at prices, with a few exceptions noted below, that were the same (and very cheap) for citizens of the country who possessed the territory as for citizens of other countries.

The impression is common that colonies are of special importance in the obtaining of raw materials, an impression which

is largely but not entirely incorrect. Having a nation's flag flying over a colony has been of no special aid in the matter of obtaining raw materials, particularly since colonies need the world market as an outlet for their materials. Furthermore, according to the League of Nations Committee on Raw Materials, colonial production of commercially important raw materials accounts for only 3% of total world production of these products.<sup>2</sup> Certain products, however, typically come from colonial areas. Many of these products are of tropical origin, such as cacao, cane sugar, copra, palm oil, tea, and sisal. Among the important products which come largely from colonies are rubber and tin, 91% of the former and 58% of the latter coming from colonial sources in the years immediately preceding the second World War.

While most colonial empires do not reserve special privileges for their own nationals in the purchase of raw materials, the League Committee on Raw Materials pointed out that, nevertheless, such nationals did in practice enjoy somewhat of a privileged situation. In general, however, raw materials were freely accessible to all on relatively even terms.<sup>3</sup> Some of the most prosperous nations have been those without colonies and with only a few resources, and which are therefore extremely dependent upon foreign nations; these include such countries as Switzerland, Sweden, and Czechoslovakia.

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<sup>2</sup> League of Nations, *Report of the Committee for the Study of the Problem of Raw Materials*, Geneva, 1937.

<sup>3</sup> Important raw materials, of which more than a fourth of the world's supply is produced in colonial areas, include the following: palm and palm kernel oil, 98% (Nigeria, Dutch East Indies, Belgian Congo); rubber, 91% (British Malaya, Dutch East Indies, Ceylon); copra, 69% (Dutch East Indies); cacao, 68% (Gold Coast, Nigeria, Ivory Coast, etc.); tin, 58% (British Malaya, Dutch East Indies); tea, 44% (Ceylon, Dutch East Indies, etc.); vanadium, 42% (South-West Africa, Northern Rhodesia); phosphates, 38% (Tunis, French Morocco, Algeria); and cane sugar, 31% (Dutch East Indies, Formosa, Puerto Rico, Hawaii, etc.). Important raw materials, of which less than 5% of the world's supply is produced by colonies, include the following: iron ore, 4.5%; nickel, 4.4%; chromite, 4.3%; petroleum, 3.9%; cotton, 3.2%; lead, 2.8%; silk, 2.5%; wool, 2.4%; zinc, 2.1%; asbestos, 1.9%; antimony, .8%; molybdenum, .8%; coal, .6%; potash, .5%; sulphur, .4%; and mercury, .1%. While these figures do not reveal potential colonial production of raw materials, they serve to indicate that colonies are more important as a source of prestige than for economic reasons. (Source: The Royal Institute of International Affairs, *Raw Materials*, London, Oxford University Press, 1939, pp. 23, 29.) Self-governing or largely self-governing areas, such as India and the Philippine Islands, are not regarded as colonies and hence are not represented in the above figures.



Political control over a territory does not have any magic way of making raw materials therefrom free, or even cheap for citizens of the controlling country. The textile manufacturer in New England must pay essentially the same price for the cotton of Texas as the textile manufacturer in Great Britain. A change in political control over a territory has ordinarily had little effect on the availability of its materials. A political change usually has involved no necessary transfer of title to private property. The mills, factories, farms, and mines ordinarily remain in possession of the same individuals as before, except as individuals may desire to move out of what has now become foreign territory, and as they therefore sell their holdings. In recent years there have been several instances where political control has been accompanied by a closed door policy and has had profound effects upon internal business and property values. Japan has been a special offender in this respect. Even in the case of Japan, however, the closing of the door has applied more particularly to the sale of foreign goods in such controlled territories, than to the export of raw materials from such territory.

Prior to the outbreak of the second World War in 1939, the trend was toward an increasing amount of colonial integration and special privilege. This was particularly the case following the Ottawa Conference in 1932 which promoted preferential treatment within the British Empire. This trend, coupled with growing protectionism all over the world, special shipping legislation, and other measures granting favored positions, was inconsistent with a prosperous and growing world trading system. It had, however, not reached a point where the accessibility of raw materials was seriously curtailed.

Not only have raw materials been available in ample amounts (except during war), but prior to the war they were offered by anxious sellers at very low prices. Raw material producers in every country were confronted with ruinously low prices, and were only too willing to sell. In some cases the prices were so low as to induce raw material producers in other countries to secure enactment of tariff barriers against the importation of foreign raw materials. Tariffs on the importation of raw mate-

rials, however, are the exception rather than the rule, largely because of opposition on the part of manufacturers who use the raw materials.

The restrictive trade policies that were built up prior to the war applied principally to imports rather than to exports, and tended to shut off markets. Inasmuch as a nation cannot import raw materials unless it exports, this interference with markets and a throttling of trade tended to make raw materials inaccessible to foreign buyers who lacked foreign exchange. Notwithstanding raw material surpluses (relative to effective demand) and prices sometimes below cost of production, nations therefore often found it difficult to obtain materials abroad. Unable to sell their own goods and services abroad, nations were unable to obtain the means of payment with which to buy from abroad. The difficulty, however, was essentially a lack of foreign exchange rather than any restrictions on raw materials themselves.<sup>4</sup> The mounting interferences with trade, and the severe depression made the problem acute, and stimulated the trend toward economic nationalism which only made matters worse.

The trend toward national self-sufficiency was thus partly the result of economic and financial difficulties and the exchange breakdown (as well as being a cause of these difficulties and breakdown), and was also inspired by political and military motives. Nations which planned aggression, as well as nations which feared aggression, sought to obtain control over essential sources of supply, to develop substitute materials, and in general to depend upon trade as little as possible. During time of war a country cannot rely on foreign sources for raw materials needed to defend itself or attack an enemy. Stock-piling is an answer only if the war is not too long. Nations thus felt themselves forced by the threatening international situation and the restrictive policies into efforts to corral resources and into nationalistic and uneconomic policies, all of which intensified the difficulty. A close connection exists between raw materials and war, but instead of the lack of raw materials for peacetime uses

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<sup>4</sup> The causes of this breakdown in international exchange are discussed in other chapters.

being a cause of war, it is rather the fear of war, or preparations for war, that cause nations to contest for resources.

Political agitators may declare that a nation needs resources and "lebensraum" and present what superficially appear to be plausible arguments; yet such protestations are largely a cloak to cover other designs, particularly militaristic ambitions. Control over raw materials is supposedly necessary in order to obtain them freely for peacetime needs so that a nation may live. This constitutes a reason or excuse for war. Raw materials, however, must be available during a war—another reason for political control on the fallacious assumption that political control will assure their availability in wartime. The circle is thus complete: war is for the purpose of obtaining necessary raw materials, and raw materials are necessary for war. The latter statement is obviously correct, war cannot be waged without raw materials; but it is not correct to say that war is necessary to obtain raw materials, or that political control assures their delivery in wartime.

In a world where war has not been eliminated the question of the accessibility of raw materials in wartime becomes largely a military rather than a political matter, particularly in view of the nature of modern warfare, dependent as it is upon a huge industrial organization and vast economic resources. If a nation is to be strong in war it must have access during war to essential raw materials, and such materials are increasing greatly in number and amount. Storing an adequate supply of materials in anticipation of war is in most instances not practical except for a short war.

In wartime the problem of raw materials is ordinarily one of transportation and combatting blockade rather than of political control. Belligerents may be able to buy the raw materials they lack, but the problem is essentially one of delivery. Thus it appears that having political control over raw materials as preparation for war is not necessarily the answer either in peace or war. Much depends upon special circumstances, and no general principle can be established as to how a nation can assure itself a supply of necessary raw materials in the event of war. Political control over an area which may be blockaded or other-

wise made inaccessible is not necessarily the solution, since such control in itself provides little assurance of an uninterrupted flow of materials, as Great Britain and America learned in the Far East.

**Restrictions upon Access to Raw Materials.**—We have seen that nations which do not possess large colonial empires have been, in peacetime, at no particular disadvantage in securing essential raw materials. This is because the prices of raw materials are ordinarily the same for citizens of the country controlling the territory as for citizens of other countries, and also because most of the important raw materials are largely not colonial products. While during the world depression, international exchange broke down and nations were unable to sell abroad, and therefore unable to buy from other countries in accustomed amounts, at the same time domestic exchange also broke down. Manufacturers, unable to sell their products at home or abroad, were unable to buy raw materials even when produced in their own countries. Raw material difficulties due to the general economic collapse are not to be confused with artificial restrictions, such as there were, which interfered with the accessibility directly or indirectly of raw materials.

Although raw materials have been in general freely available to all buyers, certain exceptions are to be noted. Several countries have levied duties upon the export of raw materials, although this practice is not general. The duties are usually not heavy, varying from 1% to 5% ad valorem, and are in most cases levied for revenue purposes and by countries which are little developed industrially. Industrialized countries, interested in buying raw materials, rarely resort to this practice.

Export duties may be either non-discriminatory or discriminatory; that is, they may be levied equally against all exports of a certain commodity, regardless of destination, or they may be reduced or lifted entirely in the case of exports going to certain countries—generally to the mother country. Portugal, France, Spain, and Italy have commonly employed discriminatory colonial export duties on certain products. In the case of the British Empire, the only discriminatory export duties apply

to tin. A prohibitive duty is levied upon exports of tin from the Federated Malay States and Johore unless the tin is destined for smelting in the Straits Settlements, the United Kingdom, or Australia. Except in the case of the Virgin Islands, the United States does not allow the use of export duties in any of its dependencies.<sup>5</sup>

Export embargoes are sometimes utilized in the endeavor to prevent the emergence of foreign competition in the production of a particular product. Thus the Philippine Islands have prohibited the exportation of Manila-hemp seed in order to preserve their monopoly of this product. Similar embargoes have been instituted by Cuba in the case of pineapple slips, by Egypt in the case of date shoots, and by the British and Dutch East Indies in the case of rubber-planting materials.<sup>6</sup>

A much more important form of restriction has developed in recent years in the form of various schemes to control the supply or price of certain raw materials. Raw material control schemes date back to before the beginning of the century, but they have increased greatly in scope and number since the first World War. This development was accelerated by the widespread depression of the nineteen thirties. The first World War greatly stimulated productive capacity of raw materials in many areas, and when the abnormal war and post-war demand ceased, a disastrous fall in the prices of these materials resulted. Not many years later came the great depression which meant a general collapse of effective demand, working further havoc with prices. It is not surprising that producers in countries controlling all or nearly all of the supply of a particular commodity were often eager to band together to influence supply and price. In several instances such action was encouraged by the government or was undertaken by the government itself.

One of the interesting examples of government effort to control raw materials was the unsuccessful attempt of Great Britain to control the price of crude rubber. For many years rubber was obtained almost exclusively from the natural rubber forests of Brazil. During the early part of this century, how-

<sup>5</sup> The Royal Institute of International Affairs, *op. cit.*, p. 53.

<sup>6</sup> Eugene Staley, *op. cit.*, p. 78.

ever, huge rubber plantations were developed in the Malay Peninsula and the Dutch East Indies. The rubber plantations grew so fast that the price of crude rubber fell from over \$2 per pound in 1910 to 15 cents per pound in June, 1921. In an attempt to raise rubber prices, Great Britain inaugurated in November, 1922 the so-called Stevenson plan. This program regulated the exports of crude rubber from British territory by means of a sliding scale of export taxes. The endeavor was to raise prices by discouraging exports. During the time the program was in effect, rubber prices fluctuated widely. Increasing to over 30 cents per pound in 1923, the price dropped to 18 cents in 1924 and then rose to over a dollar per pound in 1925. In 1926 the price fell to less than 40 cents per pound and remained at approximately this level during 1927. In 1928 the export tax on rubber was removed and the attempt at price control abandoned.

The program was suspended for several reasons. In the first place Great Britain did not control the entire supply of crude rubber, and the large Dutch rubber interests in the Dutch East Indies were profiting at British expense. They were glad to have exports from British territory reduced so that they could sell all the more, and at the improved prices. Moreover, America, the principal consumer of rubber, was displeased over the plan to raise prices and curtail exports, and began to develop its own sources of rubber. The plan emphasized to America that one of the vital raw materials which she lacked could be manipulated by a foreign power to America's harm. America, therefore, undertook to develop rubber plantations of her own in Africa, Brazil, and other parts of the world. In so far as the program did raise prices, it created ill-will, and threatened to cut off large markets in the United States and elsewhere.

The effects of the Stevenson Act were not confined to the period during which it was in effect. The high rubber prices which it encouraged resulted in the planting of extensive new rubber acreage in non-British possessions as noted. Since a period of five years must elapse between planting and commercial exploitation, the effect of the increased acreage was not serious until the world depression when, as a result of the

greatly increased supply and the seriously reduced demand, the price of rubber fell to 3 cents a pound.

The Stevenson plan illustrates some of the major weaknesses of raw material control schemes and of monopolistic practices generally. Such schemes tend to stimulate foreign production, the development of substitutes, the use of scrap material, the emergence of synthetic production as well as uneconomical methods. The Chilean nitrate and Japanese camphor monopolies were both broken by the development of processes for producing these products synthetically. The American program to raise the price of cotton stimulated the production of foreign cotton and reduced the percentage of world cotton supplied by the United States. Where control schemes are successful in raising prices, they are likely to be boom-crangs.

In spite of their difficulties and probable uneconomic aspects, raw material control plans appear to have become a more or less permanent part of the world scene. They affect such commodities as aluminum, bismuth, coffee, copper, cotton, lead, mercury, molybdenum, nickel, petroleum, platinum, potash, quinine, sisal, sugar, sulphur, tea, tin, tungsten, wheat, and zinc. Most of the schemes are non-discriminatory.

If pursued with regard for consumer interests and the public welfare, and if administered farsightedly and without interference from special groups, it is possible for control plans to serve a useful purpose in promoting orderly marketing and in enabling producers to weather economic storms. They are open, however, to grave dangers and abuse and, on the basis of past experience, the benefits may be far outweighed by the evils.

**Principal Raw Materials and Their Sources.**—The second World War disrupted trade, markets, and the production of raw materials, stimulating certain production and depressing others. It led to serious maladjustments. The present discussion of individual raw materials is based largely on the situation as it existed prior to the outbreak of war.

**METALS.**—Modern industrial civilization is founded to a large extent upon the science of metallurgy, the present age sometimes

being called an age of metals. Elaborate machinery, skyscrapers, automobiles, airplanes, ocean liners, trains, telephones, weapons of war—all owe their existence to progress in the utilization of metals. Without metals economic life would be primitive indeed.

Iron and copper surpass all other metals in industrial importance. Iron, which in the form of steel is a constituent of practically all machinery, was given a tremendous boost with the invention in 1856 of the Bessemer process of making steel from pig iron. With the introduction of this process, the annual steel production in England increased promptly from about 50,000 tons to 3,000,000 tons, the price at the same time falling by about 80%. Subsequent developments in the manufacture of steel have greatly improved its quality and extended its adaptability to different uses, simultaneously reducing production costs.

The United States is the greatest producer and consumer of steel. The iron-ore reserves of the United States are larger than those of any other country, and extraction is much higher in this country than elsewhere, amounting to 38% of the world total in 1937.<sup>7</sup> The United States exports little iron in the form of ore, but ships abroad huge quantities of bar iron, sheet iron, rails, and finished steel products. At the same time, a substantial volume of iron ore is imported into this country, chiefly from Chile and Cuba. Other countries with large iron reserves include France, Russia, Brazil, Great Britain, Newfoundland, Cuba, and Sweden. Of these countries, France, Great Britain, and Sweden are important exporters of iron, both in the form of ore and of steel.

Copper is a metal of special importance because of its utility as a conveyor of electrical energy, as well as its usefulness for war purposes. The United States is the leading producer of copper, accounting in 1937 for 32% of world production. Next in importance are Chile (18%), Northern Rhodesia (11%), and Canada (10%).

A metal of rapidly growing importance is aluminum, particularly in view of its usefulness in airplanes and for other forms of transportation. The development of aluminum within a few dec-

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<sup>7</sup> Unless otherwise indicated, all figures in this chapter are percentages of world production in 1937, and are taken from the report of the Royal Institute of International Affairs, *cit.*, p. 23 and appendices.



ades from a metal known largely in laboratories to a major industrial material forms one of the interesting chapters in modern industrial history. With the perfection of an electrical process of extraction, aluminum fell in price from \$100 a pound to a few cents a pound at the present time. The usefulness of aluminum arises from its combination of light weight with great strength and resistance to corrosion and tarnishing. These qualities make it particularly suitable in aviation. Its uses in a variety of other fields are expanding and will continue to do so as the price permits. Aluminum is produced from a compound known as bauxite, the leading producers of which are France (17%), Hungary (13%), and the United States (11%).

The importance of a particular metal to industry is not to be judged solely by the volume of its consumption, since certain metals, required only in small quantities for alloying or other purposes, are of utmost industrial importance. Among the principal alloying agents and special metals are chromium, manganese, molybdenum, nickel, tungsten, and vanadium. When added to steel in proper quantities, these metals perform such functions as increasing hardness, toughness, durability, resistance to corrosion, and raising the melting point. In most cases, only a small percentage of the alloying metal is needed to produce the desired effect. Manganese, while used as an alloying agent, is indispensable in making any kind of steel, because it is the only economical de-oxidizing and de-sulphurizing agent. Other metals which in one way or another are industrial essentials are antimony, lead, mercury, silver, tin, zinc, and magnesium, an extremely light metal which is rapidly coming to the fore.

International interdependence is nowhere better illustrated than in the case of metals. Even the United States, potentially the most self-sufficient of nations, must import virtually its entire supply of antimony, chromium, manganese, nickel, and all its tin. Antimony, which is used as a hardening agent in alloys of aluminum, copper, lead, and tin, is found chiefly in China (36%), Mexico (26%), and Bolivia (17%). Chromite, the ore from which chromium is extracted, comes principally from Southern Rhodesia (23%), substantial amounts being contributed by Turkey (16%), Russia (15%), and South Africa (13%). Russia and India produce most

of the world's manganese (40% and 18% respectively), while mercury occurs chiefly in Italy, Spain, and the United States, these countries accounting respectively for 45%, 30%, and 12% of world production in 1937. Over 90% of the known supply of molybdenum is in the state of Colorado. Canada produces nine-tenths of the world's nickel. In the Malay States, the Dutch East Indies, and Bolivia is found most of the known supply of tin, these regions in 1938 respectively producing 58%, 17%, and 16% of the world total. Tungsten occurs chiefly in China, which accounted for 46% of world production in 1937. The industries of all nations lean heavily upon these vital and unevenly scattered metals.

NON-METALLIC MINERALS: COAL AND PETROLEUM.—As iron and copper stand out among the metals, so coal and petroleum occupy a prominent position among the other minerals. Coal has many well-known uses; it is an essential in the manufacture of steel, both as fuel and as coke; it continues to be widely used in the production of steam for heat and power, in spite of growing competition from petroleum and hydroelectric power; it is used in the manufacture of artificial gas, and for numerous other purposes. Petroleum or its derivatives, besides being used extensively in gasoline and Diesel engines, as a fuel in industrial operations and as a lubricant, is acquiring increasing importance as new uses for its unique properties are developed in industrial laboratories.

North America has more than twice as much coal as any other continent except Asia. Its reserves of bituminous coal are estimated at two and one-quarter trillion tons, almost 90% of which occurs within the United States.<sup>8</sup> Practically all the world's known supply of anthracite ("hard coal") is located in a small area in northeastern Pennsylvania. Most of the anthracite mined is consumed in the eastern states. The quantity of this superior type of coal remaining underground is believed to be small, and increasing scarcity of the fuel may be reflected in a steady rise in prices. The United States leads in coal production, with 34% of the world total in 1937, being followed by Great Britain, with 19%, and Germany, with 14%.

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<sup>8</sup> R. H. Whitbeck and V. C. Finch, *Economic Geography*, 3rd ed., New York and London, McGraw-Hill Book Co., Inc., 1935, p. 164.

The United States also leads in the production of petroleum, accounting for 60% of the world output in 1938. However, almost half the estimated American supply has now been removed, and remaining oil reserves in this country are estimated to comprise not more than one-sixth of the total world reserves.<sup>9</sup> Other important producers of petroleum in order of 1938 production are: Russia, with 11%; Venezuela, with 10%; Iran, the Dutch East Indies, Rumania, Mexico, Colombia, and Iraq.

In the generation of electricity, water power is a substitute for coal, petroleum, and natural gas. Where water power exists close to centers of distribution, it may be as economical as steam-generated electricity, but frequently potential water power is found far from where it is needed. Not only is the cost of conducting electrical power over long distances great, but much of the power is lost in the process. For countries lacking coal and oil, water power resources are of special value.

Africa leads all continents in potential water power, possessing well over twice as much as Asia, its nearest rival. Virtually none of the African water power is utilized, partly because of being commercially inaccessible. Other continents, in order of estimated water power resources, are North America, South America, Europe, and Australia, the last of which has very little. Countries which have important water power resources are, in order, the United States, India, Brazil, Russia, China, Canada, and Sweden. In all these countries, most of the potential water power is unutilized, to a large extent because, while physically existent, much of it is economically unavailable. In Brazil, India, and China practically none is developed; in Russia, only a small fraction; while the United States, Canada, and Sweden employ about a third of their respective water power resources.<sup>10</sup> Utilization of the huge potential water power is increasing, and will doubtless so continue.

In addition to the basic minerals mentioned above are many others, the industrial importance of which is not necessarily indicated by the volume of output. Asbestos, important as a heat-

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<sup>9</sup> *Ibid.*, p. 173.

<sup>10</sup> Hugh B. Killough and Lucy W. Killough, *Raw Materials of Industrialism*, New York, T. Y. Crowell Co., 1929, pp. 290-295; Frank H. Simonds and Brooks Emeny, *The Great Powers in World Politics*, New York, American Book Co., 1935, pp. 46-47.

resisting substance and electrical insulator, is produced chiefly in Quebec. The United States, which is the principal consumer of asbestos, depends almost entirely upon the Canadian supply. Asphalt, extensively used in highway construction and surfacing, comes chiefly from Trinidad. Graphite, a lubricant and component of the lead in pencils, is imported from Ceylon, Madagascar, and Mexico. Mica, which is employed in glazing, flooring, roofing, and electrical insulation, is produced chiefly in the United States, India, Canada, and Russia. Nitrates, a virtual monopoly of which was formerly held by Chile, are now artificially produced on an extensive scale from the nitrogen in the air. Nitrates are important both in peace and war, being used in fertilizers and explosives. Potash, also used in fertilizers, is produced chiefly by Germany and France. Sulphur, which has numerous industrial uses, is produced mainly in the United States. International interdependence is strikingly illustrated by the world distribution of these minerals.

VEGETABLE FOODSTUFFS.—Foodstuffs constitute a large and commercially valuable part of the commodities which flow in international trade. Through world commerce numerous articles, first regarded as treasured luxuries, have come to be considered necessities. Coffee, tea, spices, chocolate, bananas, sugar—each were once food only for the very wealthy, yet now are found on the poorest table. Without world trade, the varied diet to which modern man is accustomed would be impossible.

Nations usually produce at home most of the food they consume, but in order to have the desired variety must import certain things from abroad. While all nations must import certain kinds of food, if they are to have them at all, in the case of most countries these food imports are usually about offset in value by the export of other foods. Great Britain is a notable exception, producing only about half enough food for its people. Because of a marked comparative advantage in industry, Great Britain has come to depend more and more upon outside sources for food. In the case of most countries, however, the major portion of food consumed is produced domestically.<sup>11</sup> This condition is aided by the fact that the diet of most

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<sup>11</sup> Certain important foodstuffs, such as milk (the aggregate value of which is far greater than that of any other commodity) and potatoes, enter into foreign trade only on a very small scale.

peoples is adapted to the types of food that can be provided domestically. For example, in dairy countries the consumption of cheese is high.

The leading foodstuff entering into international trade is wheat. Russia and the United States come first in wheat production, accounting respectively for 27% and 15% of the world total in 1938-1939; much of this wheat is consumed at home. The chief exporters of wheat are Canada, Australia, the United States, and Argentina. Ordinarily about 20% to 25% of the world's production of wheat enters into international trade.

Rice is to the Orient what wheat is to the western peoples. The principal rice-producing countries are China, India, and Japan. China probably leads in rice production, although accurate figures are not available. Only about 10% of the rice grown crosses national boundaries. The principal exporters of rice are India, Siam, and Indo-China.

Sugar has become a common item in the diet of all civilized peoples. Cane sugar is a tropical product, whereas beet sugar comes from temperate regions. India and Cuba are the leading producers of cane sugar, Russia and Germany of beet sugar. The United States is the largest consumer of sugar, and ranks third in the production of beet sugar. It imports a large amount of its supply from Cuba, Hawaii, the Philippines, and Puerto Rico.

Most of the other vegetable foodstuffs which enter into world trade are of tropical origin, such as bananas, cacao, coffee, copra, and tea. Half of the world banana exports originate in the eastern coast of Central America. Here large American-owned plantations, particularly those of the United Fruit Company, ship millions of bunches on refrigerator ships to all parts of the world. Cacao, from which chocolate and cocoa are made, is grown on the African Gold Coast, in Brazil, and in Nigeria. Brazil produces most of the world's coffee, 61% in 1938, Colombia being second with 11% of world production in 1938. Copra (the dried meat of coconut) and coconut oil, used both for food and soap, are produced in great abundance along the sea coasts of tropical islands. The Philippine Islands export large quantities of coconut products. India leads in tea production, accounting for 42% of the world total in 1937, being followed by Ceylon, with 21%; the Dutch East Indies, with

16% ; and Japan, with 12%. Almost all the tea produced in these areas is exported.

**ANIMAL FOODSTUFFS.**—The three classes of animal foodstuffs are meat, dairy products, and fish. Meat is a more prominent article in the diet of western peoples than in that of Orientals. Modern methods of refrigeration have made it possible to ship fresh meats thousands of miles, so that it has come to be an important item in foreign trade. Beef is shipped principally from Argentina, Uruguay, Brazil, and Australia ; lamb and mutton from Australia and New Zealand ; and pork products from the United States, Denmark, Holland, and Canada. While the United States is the leading producer of beef, domestic consumption is so great that little remains for export.

Before the outbreak of war in 1939, the principal exporters of dairy products were Denmark, New Zealand, Australia, the Netherlands, Argentina, Canada, and Switzerland. Butter and cheese were the principal dairy products exported. Denmark and the Netherlands have specialized in food production and supply much of the food for the nearby countries.

The fishing industry is of less importance in world trade than the meat and dairy industries. Japan is far in the lead in value of its fishery products.

**COTTON AND FLAX.**—The two main vegetable fibers used in the manufacture of textiles are cotton and flax, while the coarser vegetable fibers are hemp, jute, and sisal, discussed below. The principal animal fibers are wool and silk.

Cotton is the leading single commodity in international trade, the value of cotton traded being greater than that of any other item. Liverpool is the chief cotton exchange center for the world, while New York and New Orleans are the two principal American centers dealing in cotton. The production of raw cotton varies greatly from year to year, mainly as a result of climatic conditions. Although cotton is the leading textile fiber, it has had a far shorter history in cloth manufacture than has wool, flax, or silk. It was not until the invention in 1793 of the cotton gin, a machine for removing the seed from the fiber, that cotton production became practicable on a large scale.

The United States is the largest producer of cotton, and for many years has produced over half the world's output. The United States is also the leading consumer of cotton. Gradual shifts in the sources of cotton supply have taken place, and during the past few years the proportion of cotton produced by the United States has declined. Other producers of increasing importance are India, with 12% ; Russia, with 10% ; and China, with 9%. The expansion of foreign cotton production has been stimulated by the artificially high price for American cotton supported by the United States Government. The United States for many years prior to about 1930 exported from half to two-thirds its cotton production, but in recent years this percentage has declined, due in large measure to the high price maintained in America. In the 1938-1939 season the United States exported only 30% of its production. In the 1939-1940 season the United States exported as much cotton as all other countries combined. In the 1940-1941 season, however, the United States fell to third place with 1,141,000 bales, being preceded by India with 1,670,000 bales and Brazil with 1,346,000 bales. The decline was due partly to the closing of the European market by the war, but also to a preference by other markets for lower-priced Indian and Brazilian cotton. The principal importers of raw cotton are normally Japan, Great Britain, Germany, and China. These countries are important manufacturers of textiles, and reexport large quantities of cotton in finished form.

Industries have various uses for cotton. While cotton is used chiefly in the manufacture of textiles, certain types of cotton fiber are used in the making of celluloid and also of explosives, so that cotton is an essential material of war. The seed of cotton is made into cottonseed oil, which has various industrial uses, and into oil-cake, a cattle food and fertilizer.

Flax, the other principal vegetable textile fiber, is grown both for manufacture into linen and for seed. It is grown separately for the two purposes, since seeds are of proper quality only when mature, by which time the fiber is unsuitable for cloth manufacture. The seed is used for linseed oil, an important product used in paint manufacture and in other ways, and for linseed cake, a cattle food. Among the principal flax-seed producing areas are the United States, Canada, Argentina, and Russia. Russia is also the leading

producer of flax for linen manufacture, accounting in 1937 for 70% of the world output. The British Isles manufacture large amounts of linen, most of which is exported. While linen manufacture is not a large industry in the United States, this country is a leading exporter of linseed cake, the chief consumers of which are Holland, Belgium, and Great Britain.

**WOOL AND SILK.**—Wool ranks next in importance to cotton as a textile fiber, being followed by flax. While most wool is obtained from sheep, substantial amounts are secured from angora goats, llamas, vicunas, alpacas, and camels. Wool is used both in the manufacture of cloth, often in combination with other fibers, and in the production of felt, which is not woven but pressed. London is the principal wool center of the world.

Australia is the largest exporter of wool. Argentina, the Union of South Africa, and New Zealand are also large exporters. While the United States is a leading producer of wool, the output is not sufficient for domestic consumption, and must be supplemented by imports. The number of sheep raised in this country, however, has increased rapidly in recent years. The other principal importers of raw wool are Great Britain, France, Germany, and Belgium.

Silk, the other prominent animal fiber, ranks last in importance among the four leading textile fibers. In early times, silk was worth its weight in gold, and is still somewhat of a luxury, although it is becoming increasingly less so. It is encountering serious competition from other and synthetic fibers. The production of raw silk requires a large amount of hand labor, and is therefore confined to areas where labor costs are low. The processes of silkworm culture and silk reeling are delicate ones requiring much patience, attention, and skill. The very low wages which prevail in the Orient give oriental countries a comparative advantage in the production of raw silk. The climate of other regions is suited to the growing of silk cocoons, but they are not grown because of higher labor costs.

Japan is by far the leading producer and exporter of raw silk. Of the total raw silk output of the world, Japan in 1937 produced 77%, most of which was exported to the United States. China



ranks next, followed by Italy. The United States is the principal importer of raw silk and the leading manufacturer of silk products. About four-fifths of the raw product exported from other countries is bought by the United States for manufacture in the North Atlantic states. The war and the cutting off of silk imports into the United States have had profound effects upon the silk industry, encouraging the use of substitutes; many of the effects appear to be of a permanent nature.

**FOREST PRODUCTS.**—While lumber is the most important of the forest products, there are many others of significance, such as resins, turpentine, gums, tanning materials, medicines, fibers, dyes, and foods. Woodpulp, from which ordinary paper is made, is particularly important for newspapers and magazines. Huge quantities of woodpulp, and paper made from it, are imported into this country each year, mainly from Canada. The distribution of the world's wood and timber resources is indicated by Table 7.

TABLE 7. WORLD TIMBER RESOURCES<sup>a</sup>  
(Per cent of total world acreage)

Continent	Conifers <sup>b</sup>	Temperate Hardwoods	Tropical Hardwoods	All Conifers <sup>b</sup> and Hardwoods
Africa .....	...	1%	21%	7%
Asia .....	34%	48	18	33
Australia-Oceania ..	...	1	7	3
Europe .....	22	16	...	13
North America ....	40	24	3	22
South America.....	4	10	51	22
	100%	100%	100%	100%

<sup>a</sup> Adapted from table in Killough and Killough, *Raw Materials of Industrialism*, p. 160.

<sup>b</sup> Conifers are plants of the pine family.

The United States possesses almost half a billion acres of forest land. Although its domestic consumption of forest products far exceeds its exports, this country usually leads the world in exports of lumber. Countries whose exports of forest products are ordinarily far in excess of their imports include Canada, Sweden,

Finland, Norway, Russia, and Poland. Much of Canada's wood is exported in the form of pulp for paper manufacture. From the forests of Central America come large quantities of mahogany and other tropical woods. Mahogany is a prominent export of Nigeria and the Gold Coast in Africa.

MISCELLANEOUS INDUSTRIAL MATERIALS.—There remain a number of industrial materials which are non-mineral in character. Of these, rubber is among the most important. The United States is the principal consumer of rubber, absorbing most of the world output. About half of all the rubber produced is used for automobile tires, the remainder being used for insulation, clothing, medical supplies, shoes, tubing, etc.

Almost all the world's rubber is now produced on cultivated rubber plantations—wild rubber, found chiefly in Brazil, being no longer of great commercial consequence. During the war, however, all sources of rubber are being exploited to the utmost and synthetic production is being greatly expanded. Practically all rubber plantations are in southeastern Asia and nearby islands, although cultivation in Brazil is expanding. British Malaya is the largest producer, accounting for 41% of world production in 1938. The Dutch East Indies are second, with 33%. The chief rubber-producing regions were, prior to the war, thus controlled by the British and Dutch.

Other vegetable materials used in industry include hemp, sisal, and jute. Russia and Italy lead in the production of hemp, from which rope is manufactured. Most ship rope is now made of Manila hemp (abaca), which is grown exclusively in the Philippine Islands. Sisal, used for making binding twine, is produced chiefly in Tanganyika (East Africa), the Dutch East Indies, and Mexico. Jute, from which burlap and gunny sacks are made, is grown almost solely (99%) in India. Most of the jute is exported from India in finished form.

Another commodity which enters into foreign trade in large amounts is tobacco. Because of its adaptability to varied climatic conditions, tobacco can be grown in many parts of the world. The United States leads in tobacco production, accounting in 1937-1938 for 28% of the total world output. Next in order are India,

TABLE 8. LEADING PRODUCERS OF RAW MATERIALS <sup>a</sup>

RAW MATERIALS	LEADING PRODUCERS					
	1		2		3	
<b>Metals</b>						
Iron ore.....	United States	38%	Russia	14%	France	12%
Copper.....	United States	32	Chile	18	N. Rhodesia	11
Lead.....	United States	25	Australia	15	Mexico	13
Zinc.....	United States	31	Australia	11	Canada	9
Tin <sup>b</sup> .....	Malaya	28	Dutch E. Indies	18	Bolivia	16
Bauxite (aluminum)	France	17	Hungary	13	United States	11
Manganese ore.....	Russia	40	India	18	Gold Coast	9
Nickel.....	Canada	89				
Chromite.....	S. Rhodesia	23	Turkey	16	Russia	15
Tungsten ore.....	China	46	Burma	15	United States	9
Molybdenum.....	United States	92				
Vanadium.....	Peru	30	S. W. Africa	30	United States	25
Antimony.....	China	36	Mexico	26	Bolivia	17
Mercury.....	Italy	45	Spain	30	United States	12
Gold.....	South Africa	34	Russia	15	United States	12
Silver.....	Mexico	31	United States	27	Canada	9
<b>Other Minerals</b>						
Coal.....	United States	34	United Kingdom	19	Germany	14
Petroleum <sup>b</sup> .....	United States	60	Russia	11	Venezuela	10
Asbestos <sup>c</sup> .....	Canada	54	Russia	25	S. Rhodesia	10
Potash.....	Germany	61	France	15	United States	8
Sulphur.....	United States	82	Italy	11	Japan	6
<b>Foodstuffs</b>						
Wheat <sup>d</sup> .....	Russia	27	United States	15	India	7
Coffee <sup>b</sup> .....	Brazil	61	Colombia	11	Dutch E. Indies	5
Tea.....	India	42	Ceylon	21	Dutch E. Indies	16
Beet sugar <sup>d</sup> .....	Russia	23	Germany	20	United States	16
Cane sugar <sup>e</sup> .....	India	19	Cuba	17	Dutch E. Indies	8
Cocoa <sup>e</sup> .....	Gold Coast	32	Brazil	18	Nigeria	13
<b>Textile Fibers</b>						
Cotton <sup>e</sup> .....	United States	50	India	12	Russia	10
Flax.....	Russia	70				
Wool.....	Australia	26	United States	12	Argentina	10
Silk.....	Japan	77	Thailand	9	Italy	6
<b>Other Products</b>						
Tobacco <sup>e</sup> .....	United States	28	India	20	Russia	10
Hemp <sup>d</sup> .....	Russia	34	Italy	26	Yugoslavia	12
Manila hemp.....	Philippine Is.	100				
Sisal.....	Tanganyika	45	Dutch E. Indies	24	Mexico	22
Jute.....	India	99				

<sup>a</sup> This table is adapted from data in the Royal Institute of International Affairs study, *Raw Materials*, p. 23. The table shows the percentage of world production contributed by the three leading producers. Unless otherwise indicated, figures are for 1937.

<sup>b</sup> 1938.

<sup>c</sup> 1936.

<sup>d</sup> 1938-1939.

<sup>e</sup> 1937-1938.

with 20%, and Russia, with 10%. Although Turkish tobacco is noted for its excellence, Turkey produces less than 3% of the world tobacco crop.

Animal hides, the basic raw material in leather manufacture, figure in international trade to a much greater extent than does leather itself. In the form of leather, hides have a wide variety of uses, but the greatest single consumer of leather is the shoe industry.

While the United States leads the world in hide production, the domestic supply is considerably less than domestic consumption. To meet this deficiency, the United States imports quantities of hides—chiefly from Argentina, Colombia, Uruguay, and Canada. The European countries are large producers of hides, but must also import substantial amounts to satisfy their needs. Since there are many kinds and grades of hides, these countries both export and import hides.

Certain important raw materials do not enter prominently into international trade. Materials which are generously scattered over the earth, and which combine large bulk with low value, rarely cross international boundaries, since transportation costs make such trade unprofitable. Thus building materials, such as bricks, cement, and stone, are ordinarily produced and consumed within national or local boundaries, even though differences in quality may exist. Coal, in spite of its bulk, is somewhat of an exception, and in the case of Great Britain is a major export, although its importance as such is declining. The United States, which has a large supply of coal that it could export, exports only about 4% of its annual production. Certain crops, such as oats and corn, form only a minor part of world trade.

## CHAPTER 5

### OCEAN SHIPPING AND TRADE ROUTES

**Development of Modern Shipping.**<sup>1</sup>—The phenomenal growth of foreign trade within the past century could not have taken place apart from the revolutionary developments in ocean transportation. About 75% of foreign trade, according to weight, moves by sea.<sup>2</sup> Until the nineteenth century all ocean commerce was transported by means of sailing vessels. As early as 1775 a successful steam vessel had been built as an experiment, but it was not until the work of Robert Fulton in the first decade of the nineteenth century that the steamship showed signs of becoming a thoroughly practical and profitable invention. Fulton's *Clermont*, launched in 1807, succeeded in making the 150-mile journey up the Hudson River from New York to Albany in 30 hours, which excelled the performance of the best sailing vessels.

The first successful European steam vessel was the *Comet*, completed in 1812, which made regular trips between Glasgow and Greenock, Scotland. In 1819, the famous *Savannah*, a steam-equipped ship, succeeded in making the passage across the Atlantic. This voyage, however, was made chiefly with the aid of sails. All the early steamships used sails for auxiliary power, and the *Royal William*, a Canadian steamer, is usually regarded as the first ship to cross the Atlantic by steam power alone. This feat was accomplished in 1833. In 1838 the steamboat *Sirius* made the trip from Cork to New York in eighteen days.

A new era of ocean transportation was ushered in with the building of the *Great Western*, completed in 1838. Designed

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<sup>1</sup> Additional discussion of the development of shipping, transportation, and communications is contained in Chapter 1.

<sup>2</sup> League of Nations, *World Economic Survey*, 1939/1941.

for regular voyages between Europe and the United States, the 212-foot vessel attracted much attention and proved remarkably successful.

Meanwhile, other important developments were taking place. After much experimentation, the screw propeller was developed as a substitute for the paddle wheel, and was introduced in ocean vessels about 1840. Before many years this method of propulsion had completely replaced paddles in ocean transportation. A single propeller was used at first, but later twin-screw, triple-screw, and finally quadruple-screw ships became common.

About the same time that the screw propeller was being introduced, iron ships began to be constructed. The increasing size and speed of ocean vessels necessitated sturdier ships than could be built of wood. In 1843 appeared what may be called the first modern ocean steamship, the *Great Britain*. Besides being screw-propelled and built of iron, this ship contained other important innovations which were widely adopted in later vessels. During the last two decades of the nineteenth century, steel rapidly replaced iron as a shipbuilding material. The old wooden sailing ships with their long history on the seas were seen less and less. Recent improvement in the designing of ocean ships are considered later in the chapter.

**Types of Vessels.**—As in other forms of transportation, ocean shipping, to be profitable, must be guided by economy and speed. These two objectives are to some extent opposed to each other, since greater speed can only be attained at disproportionately increased cost. Since the needs for speed and economy vary with different types of shipment, ocean vessels vary greatly in design according to the purposes for which they are intended.

The most impressive, although by no means the most important type of vessel, is the huge "ocean greyhound" or "superliner," which specializes in the transportation of passengers, mail, and high-grade freight. The *Queen Mary*, *Queen Elizabeth*, and ill-fated *Normandie* are among the most recent of these vessels. As a vessel of this type is built for speed, much

potential freight space must be sacrificed in its design so that it can plow through the water faster. The newer and more luxurious of these ships are frequently booked to capacity, even in dull periods, since most ocean travelers prefer them to the older and slower vessels. Consequently, although very expensive to construct and uneconomical to operate, liners of this type often appear to earn good profits during their first few years. Considering the entire life of such vessels, they are unprofitable. The leading steamship companies have felt that they must have at least one of these super-ships for advertising purposes and for the sake of prestige. They are now facing, however, keen competition from the airplane.

As in the railroad industry, the carrying of passengers provides only a minor part of the income in ocean shipping. While the freight boat, like the freight train, may be much less spectacular than the luxurious express liner or streamlined train, it is the freight carriers which earn by far the most money for their owners. Most of the boats of the world are, in fact, primarily or exclusively for the transporting of freight. In between the ocean greyhound and the vessel designed solely for freight are many types of combination passenger-and-freight vessels, varying greatly in size, speed, and appearance.

Freight ships may be classified in a number of ways. Ships of a specialized type, such as refrigerator vessels or oil tankers, are often owned by the company which produces the articles thus transported. The United Fruit Company, for instance, owns a fleet of refrigerator ships which it operates in the banana trade between the United States and Central and South America. Several of the large oil companies have their own tankers which carry oil to all parts of the world. The great bulk of shipping, however, is carried on by independent steamship companies.

Vessels operated without any regular schedule or fixed ports of call are known as "tramp ships" or "tramps." The tramp ship determines its course according to where cargo is located. The ship is thus free at all times to take advantage of the most profitable shipping opportunities, a great advantage from the standpoint of the operating company. Tramp vessels are often

leased by their owners to operators, sometimes for considerable periods of time. An operator, having rented a ship on a time basis, can proceed to charter it to individual exporters on a trip basis.

Tramp shipping has declined greatly in importance in recent years. This is partly because of the growth of foreign trade and of the larger number of ports where a steady supply of goods is constantly awaiting shipment. It is also because of the increased need for regularity of shipment and freedom from delay. Consequently, much the larger portion of ocean shipping has come to be done by steamship lines which operate vessels on regular schedules between specified ports. In 1914, three-fourths of the world's ocean freight was carried by tramp ships, while by 1939 only about one-fourth of the shipping of the world was done in this way. Only in Japan and Greece did tramp tonnage gain in relative importance. The United States has practically no tramp ships except a very few engaged in coastwise trade.

**Progress in Ship Design Since 1900.**—Vast improvements in ship design and construction have been made in recent years. Not only have new forms of motive power and new types of engines been developed, but the efficiency of the steam engine has been greatly increased.

Until the twentieth century, steam engines used in ocean-going vessels were of the so-called "reciprocating" type, a type which utilizes pistons and which is found in railroad locomotives. While this type of engine had been developed to a high degree of efficiency, it had the disadvantage, when built in the large sizes demanded by the modern ocean liner, of causing troublesome vibration. During the eighteen nineties, experiments were made in England to determine the practicability of employing the steam turbine in ocean transportation. This type of steam engine works on the same principle as the water-wheel, using jets of steam instead of water. The application of the steam turbine to ocean vessels was an immediate and outstanding success. After being tried in smaller ships, the turbine was installed in the Cunard liner *Mauretania*, launched in 1907, which held the Atlantic speed record for over twenty years.



Steam turbines of the present day are much more efficient than those built a few years ago. Whereas formerly steam pressures of 200 pounds per square inch were the rule, the modern practice is to use pressures of from 400 to 600 pounds. Boilers of greatly improved design have been developed, made of new alloys which resist corrosion. These changes have made possible marked savings in fuel.

A conspicuous twentieth century development has been the substitution of oil for coal as fuel. In 1914-1915, according to Lloyd's Register of Shipping, only 1,310,000 tons gross of vessels were fitted with oil-burning boilers. By 1938 this figure had climbed to the total of 20,058,000 tons. The world tonnage of vessels that year, including motor-ships, was divided between oil-burning and coal-burning vessels in the proportion of 53.3% for oil burners, and 46.7% for coal burners.

While steam still holds unquestioned sway as the chief source of power for ocean-going vessels, other sources of power are increasing in importance. The rise in importance of Diesel engines has been particularly rapid. Vessels powered directly by Diesel engines are known as motor ships. The gross tonnage fitted with Diesel engines increased from 234,000 tons in 1917 to 14,930,000 tons in 1938. During this period extensive improvements in Diesel engines took place. Their weight was reduced at the same time that their power and efficiency were increased. Diesel engines have the advantage of saving valuable space in the hold of a ship.

Electric power has also been used increasingly for vessels. Generation of the electricity is generally accomplished by steam turbines, although Diesel engines are sometimes used for this purpose. During recent years many large ships, including war vessels, have used "turbo-electric" power.

Improvements in design have accounted for increases in speed for all types of vessels. The typical freight ship of twenty or thirty years ago had a cruising speed of about ten knots per hour. The typical freighter built today betters this speed by from three to five knots per hour, sometimes more. Faster ships are more economical than slower ones. A fourteen-knot ship will make several more trips per year than will a ten-

knot ship. Most of the expenses are not increased by the extra speed. While fuel costs may be greater, items which do not increase because of the greater speed are interest, wages, depreciation, insurance, repairs, and storage.

The average length of time for Atlantic crossings on the faster vessels is continually growing less. The "ocean greyhounds" have actively vied with each other for speed records. The French liner *Normandie* in August, 1937, was the first ship to cross the Atlantic in less than four days, making the westward passage from Bishop Rock, England, to New York in three days, twenty-three hours, and two minutes. The *Normandie* had previously taken the mythical blue ribbon from its rival, the huge *Queen Mary*.

Building and operating ships with a view to speed records is a costly process. High speeds require a great deal more power and fuel. This means that ships must be larger in order to accommodate the increased power plant and fuel capacity. A larger ship, however, requires more power to propel it, so that the power plant must be enlarged again to provide for the greater bulk.

**Ocean Freight Rates.**—Ocean shipping is extremely competitive, and in this particular is in contrast to the railroad industry, which is usually monopolistic. The competitive character of ocean shipping is due largely to the fact that, once on the high seas, ships are on fairly equal terms and have the same factors to contend with. The ocean is a free highway over which vessels of all types and nationalities can roam.

The supply of ships cannot change rapidly, although vessels may be withdrawn from use when freight rates go down, and can be quickly returned to service when rates rise. A supply of idle ships which can be placed in service tends to check rapid increases in ocean freight rates. When there is a general shortage of vessels, the situation is, of course, different. The demand for shipping services is subject to wide and often irregular variations as a result of the seasonal character of certain industries, business fluctuations, tariffs, and wars. These fluctuations tend to prevent ocean freight rates from showing much

stability. Due to the war, freight rates rose from 100 in August, 1939, to 494 in March, 1941, according to Lloyds List (78 world routes).

Overbuilding is a danger to which the shipping industry has been susceptible, with the result that profits have on the average not been good. This is partly due to the fact that ships, once built, last a long time; when conditions are prosperous, ships are built on the supposition of a continuance of prosperity. Overbuilding is also partly the result of artificial stimulation by government subsidies to shipbuilders and shipowners. The needs of the first World War produced a temporary shortage of ships and led to frantic building, causing an oversupply when the war was over. Rapid construction of ships during the second World War and the huge tonnage sunk make the future situation uncertain. Shipbuilding capacities, however, have been greatly expanded.

A shipping company which is not making a profit may still continue to operate its vessels rather than to lay them up. The fixed charges of shipping companies are very large. Many expenses—interest, for example—continue whether ships sail or not, and any earnings that can be made toward these expenses are better than nothing. The lowest freight rate which a company can afford to offer in situations of this kind is that which covers operating expenses, or prime costs—that is, the direct costs of moving boat and cargo, and which would not have been incurred had a trip not been made. Costs of this kind include those of fuel, loading and unloading, port dues, and wages of seamen. If necessary, it would pay a steamship company to charge freight rates only slightly above the operating expenses, although the company would show a deficit unless all other costs were also met. Shipping companies are not alone in this type of situation.

In special cases operating expenses do not constitute the lower limit in the determination of freight rates. A tramp vessel may be leaving for a port where a highly profitable shipment is waiting. In the port that it is leaving, only low-grade bulky freight may be available for shipment. The ship, needing ballast, might be willing to carry this freight for a rate barely in

excess of the loading and unloading costs. It would lose nothing since the trip would be made anyway.

**Steamship Conferences.**—In order to check the tendency toward cutthroat competition, many so-called steamship “conferences” have been formed. These are voluntary associations of steamship companies serving a common route, wherein the companies agree to cooperate in maintaining freight and passenger rates at certain levels, and to cooperate in other matters. Often a minimum rate is agreed upon, below which none of the member lines is supposed to carry freight. A lower rate is usually allowed companies with slower vessels. In some of the conferences, earnings are divided among members on a predetermined basis. These are known as “money pools.” There are also “traffic pools,” in which traffic is apportioned among the members rather than earnings. There are about 122 conferences involving United States ports, including about 300 steamship lines.

Steamship conferences are semi-monopolistic, and sometimes resort to practices regarded as improper. New lines have not only been refused membership in a conference, but have been actively fought. Rebates have been offered to exporters for not patronizing a new line. There is a limit, of course, to the extent to which practices of this kind are effective. If freight rates are unreasonably high, tramp vessels may come to the scene and force rates down. Government regulation also serves to check practices that are contrary to the public interest. American steamship conferences are regulated by the Maritime Commission, provided for in the Merchant Marine Act of 1936. According to an act of Congress, conferences are exempt from the anti-trust laws. In periods of good business, many conferences disintegrate because better business lessens the need for cooperation among the lines.

Strange as it may seem, the conferences are usually strongly supported by exporters and importers, the customers of the steamship companies. Exporters and importers desire to know definitely what transportation costs are going to be, so that they can make contracts with assurance that freight-rate changes will not take away the profits.

**Government Subsidies to Shipping.**—Most governments aid their shipbuilders and shipowners with financial assistance of various kinds. The reasons for this policy are, first, a large merchant marine is a great advantage in time of war, as recent events have made clear. Furthermore, a war between other nations might interfere with the shipping of a country lacking a merchant marine. In the second place, a merchant marine is regarded as of benefit to the development of a country's foreign trade and to the expansion of foreign markets. Nations also desire to see their flags in foreign ports for matters of national prestige.

Because of intense competition in the shipping industry, together with government subsidies, returns on invested capital have been characteristically low and often uncertain. This is the case in nearly all countries. Consequently, if countries, particularly those not in a position of comparative advantage with regard to shipping, desire a thriving merchant marine, they must grant the industry substantial governmental assistance.

When a country undertakes to subsidize its shipping industry, other countries are practically compelled to follow its example if they wish to retain their relative status as shipping nations. As in the case of tariffs, the granting of subsidies tends to become competitive. The American Merchant Marine Act of 1936 provides that if aid paid to an American operator is inadequate to offset the effects of subsidies received by foreign competitors, a countersubsidy may be granted. Shipping subsidies, once established, are exceedingly hard to remove because of fear of foreign competition.

Government shipping subsidies (also called subventions or bounties) take many forms. The principal of these are loans at exceptionally low interest rates, highly lucrative mail contracts, the limitation of coastal trade to ships owned by domestic lines, lower tariffs, or preferential railway rates on goods carried on domestically owned ships, and outright grants of money.

Great Britain, which has for a great many years ranked first in world shipping, has in recent years actively encouraged those steamship lines that were the most troubled with foreign

competition. Great Britain, however, probably has the least aggressive subsidy program of the leading maritime countries. Its mail contracts with British shippers offer only a moderate amount above the actual cost of shipment. The government, however, has granted extensive construction loans, and has subsidized the operation of some ships, notably the *Queen Mary*. Construction of the companion ship to the *Queen Mary*, the *Queen Elizabeth*, was financed by the government.

The Trade Facilities Act of 1926 provided for loans to leading British industries, including shipbuilding. Prior to that time governmental loans at low interest rates had on occasion been extended to shipbuilders. In 1937 Great Britain had \$130,000,000 in loans outstanding to shipbuilders at low rates of interest. In comparison to the subsidy programs of France, Italy, Germany, and the United States, British aids to shipping have been moderate.

France has subsidized shipping longer than any other nation, but has never succeeded in attaining top rank. A large percentage of the present merchant marine was built with government loans, and nearly all of it receives subsidies. The German merchant marine was formerly independent, but is now under the control of the government. The government is said to own 75% of the stock of the North German Lloyd and the Hamburg-American lines. Ship construction and operation have received substantial subsidies from the German Government. The merchant marine of Italy is essentially owned and operated by the Italian Government. Japan has actively encouraged the expansion of her merchant marine, but because of low wages and operating efficiency has not needed to grant subsidies. Construction loans have been made, and bounties given to pioneer new services. The United States has subsidized shipping generously since the first World War taught this country that it needed a merchant marine. The Merchant Marine Act of 1936 changed matters considerably, providing for cash subsidies in place of expensive mail contracts. American subsidies are discussed in Chapter 32.

Aggressive government subsidies to shippers do not insure for a nation a thriving merchant marine. The factor of comparative advantages is much more important than government

assistance. Great Britain prior to the war, was carrying about two-thirds of its own foreign trade and about 45% of the entire world's ocean trade, principally because it had a comparative advantage in the shipping industry.

**World Shipping, 1914-1932.**—The first World War created serious maladjustments in shipping. An immediate result was to create a temporary shortage of merchant vessels. Part of this shortage was due to the destruction of ships by submarines, and part to the withdrawal of vessels for military purposes. Since ships were vital to the Allied powers, ship construction was undertaken on an unparalleled scale.

When the war was over, shipping participated in the short-lived boom. Shipping prospered partly because nations, unable to obtain desired goods during the war, now placed large orders as their accumulated demands were released. Furthermore, because of the destruction of ships by submarines, tonnage was relatively scarce. Shipbuilding therefore continued after hostilities had ceased, and freight rates remained at extremely high levels for over a year after the Armistice.

The result was a tremendous overbuilding of ships. By 1921 the American merchant marine engaged in foreign trade stood at slightly over 11,000,000 tons, compared with only 1,000,000 tons in 1913. In spite of the very high construction costs, all the shipbuilding nations continued to build ships. Germany, which had not only been divested of its merchant fleet by the Treaty of Versailles, but had also been obliged to build ships for the Allied powers, proceeded energetically to rebuild its own merchant marine. In a few years its pre-war tonnage was largely replaced. By the end of 1923, when the volume of international trade was about 15% less than before the war, as a result of the sharp depression beginning in 1920, the volume of ocean tonnage was over 40% greater than in 1913.

An immediate effect of the extensive building program, coupled with depression in trade, was an inevitable collapse in freight rates,<sup>3</sup> and a large amount of idle shipping. The situation was rendered worse by the fact that operating costs

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<sup>3</sup> According to the index of the London *Economist*, ocean freight rates dropped from 594 in February, 1920 to 110 for the year 1923 (1913=100).

remained about twice as high as before the war. In 1923, idle tonnage amounted to approximately 8,000,000 tons, half of which belonged to the United States. Nevertheless, total world tonnage, spurred on by government subsidies, continued to increase, notwithstanding considerable scrapping of vessels. By 1929 the registered tonnage of the world amounted to 65,600,000 tons, an increase of almost 50% over that of 1913. The volume of world trade for 1929 was only one-fourth greater than before the war. It is not surprising that in this peak year of prosperity, ocean freight rates were still depressed.

Accompanying the world depression, maladjustments in international shipping became more apparent. Few industries suffered more from the depression than did shipping. The distress was due not only to the collapse in world trade, but to a continuation of shipbuilding under governmental stimulus. Governments continued or increased their financial assistance to shipbuilders, so that the result was a huge volume of idle tonnage. In the summer of 1932, the low point in the depression, about one-fifth of the world's tonnage, or approximately 14,000,000 tons, was idle. Furthermore, most ships that were operating were carrying only partial loads.

**World Shipping Since 1932.**—Little improvement occurred during the next two years, 1933 and 1934, although beginning in 1935 conditions became better. An increased demand for raw materials caused the outlook for shipping to brighten. The improvement during 1936 and 1937 was particularly noticeable, being reflected in a rapid rise in freight rates and less idle tonnage. According to the index of the London *Economist*, tramp freight rates increased from 76.3 in May, 1936, to 133.1 in May, 1937. Most of the improvement was due to general economic recovery throughout the world, but an important part was caused by demands of the rearmament programs of the leading nations. Reduction of some of the trade barriers also assisted in the revival of world trade and shipping.

Emergence of new markets, as well as the revival of old, aided shipping. The industrialization of eastern Asia, Africa, and parts of South America created new demands for coal, oil,



copper, and steel. American exports of automobiles, electrical equipment, and machinery to certain countries returned to levels equaled only in the most prosperous years. In 1939 the world's merchant marine totaled 68,500,000 gross tons, having increased from 43,100,000 tons in 1913. The 1939 figure almost equaled the peak of 68,600,000 tons reached in 1931.

Improvement in the shipping industry prior to the war was aided by the extensive scrapping of obsolete vessels. In 1934 Great Britain inaugurated a "scrap-and-build" campaign. This provided a government subsidy for the building or modernizing of ships, on the condition that for every ton of new shipping built, two tons of existing shipping be scrapped, and that for every ton modernized one obsolete ton be scrapped. The result was that while British tonnage declined to some 3,000,000 tons less than the amount in 1930, it was much more efficient and economical.

The outbreak of war in 1939 radically altered the world shipping situation, creating an intense demand for ships. American vessels were prevented by the United States Neutrality Act, until amended in November, 1941, from carrying on trade with European belligerents; nevertheless, American shipping prospered because of exceptionally heavy trade with areas not affected by the neutrality legislation.

Great Britain commenced the war with a total of about 21,000,000 gross tons of shipping, including Dominion shipping. The losses from German attacks were not serious until after Dunkirk when sinkings mounted rapidly. By the end of October, 1941, British and Allied losses from enemy action had totaled 7,850,000 tons. Gains from captured vessels, together with transfers and charters from neutrals and Allied countries, are estimated at between 9 and 12 million tons. The net increase in tonnage, however, is misleading since allowance should be made for the fact that before the war about one-third of British imports were carried in foreign ships, that the losses mentioned above do not include those from ordinary maritime risks which in wartime are about ten times the peacetime rate, and that the speed and efficiency of ships are reduced to adapt to convoys and other conditions including much greater distances between

ports. New construction in Great Britain is estimated at about 1,500,000 tons in 1941.

The United States on June 30, 1939 possessed an ocean-going merchant marine of 8,135,000 gross tons consisting of 1,398 vessels. Of these, however, only 319 vessels, representing 2,094,000 tons, were engaged in foreign trade. Approximately 1,750,000 tons, 306 ships, were laid up. The situation, it will be noted, was thus materially better than at the outbreak of the first World War, when this country had only about 1,000,000 tons. The improvement was largely due to the Merchant Marine Act of 1936 which was designed to rehabilitate the country's failing shipping position which had continuously deteriorated since shortly after the end of the first World War. The Maritime Commission, created by the Act, had by 1939 actively promoted the construction of ships. When the United States entered the war the construction program was greatly expanded and the goal of 8,000,000 tons of new ships set for 1942, and 15,000,000 tons for 1943, which compared to an actual construction in 1941 of about 1,100,000 tons. The American merchant marine is discussed in more detail in Chapter 32.

**Trade Routes.**—Trade routes are the lanes over which the commercial vessels of the world travel. The location and direction of these lanes are governed largely by the location of the principal world ports. A trade route between two ports is ordinarily the shortest route, but this is not always the case. Particularly was this not the case in former years, when wind was the motive power for vessels. Trade winds and ocean currents were then most important considerations, and frequently entailed a route which was far from the shortest in distance. Modern steamships, however, ordinarily pay little heed to either of these factors, although such conditions are not ignored.

If there are no land obstructions between two ports, the shortest route is an arc of a "great circle"—i.e., a circle equal to the circumference of the earth. In two notable instances, trade routes have been drastically altered by the building of canals—the Suez Canal and the Panama Canal. These canals save thousands of miles and are of benefit to practically all the

ports of the world. The distance saved by routing vessels through these canals is indicated by the following table:

SAVING IN NAUTICAL MILES BY PANAMA CANAL ROUTE

	To San Francisco	To Valparaiso	To Yokohama
From New York.....	7,873	3,747	3,768
From Liverpool .....	5,666	1,540	....

SAVING BY SUEZ CANAL ROUTE

	To Bombay	To Batavia	To Hong Kong
From New York.....	3,409	1,557	2,293
From Liverpool .....	4,541	2,689	3,410

The Suez Canal, which severs northern Africa from Asia Minor, was opened in 1869, and is 104 miles long. Unlike the canal at Panama, the Suez Canal is a water-level canal without locks. The Panama Canal is 50 miles long, and was completed in 1914 at a total cost of over half a billion dollars. Both of these projects have been very successful, and have enjoyed continually increasing traffic. In 1930, for the first time, traffic through the Panama Canal exceeded that through the Suez Canal. In that year, cargo through the Panama Canal amounted to slightly over 30,000,000 tons, while that through the Suez Canal stood at 28,500,000 tons. In 1931, however, the Suez Canal again was first in traffic.

Trade routes are not fixed, but change with conditions. The process may be sudden, as with the opening of a canal, or it may be gradual, as when trade shifts from a port of declining importance to one which is growing in size. The artificial development of a harbor, such as that of Los Angeles, alters trade routes, as does the growth of population or the industrialization of certain areas. Wars, tariffs, markets, and many other factors all contribute to the location and shifting of the trade routes.

The principal trade routes radiate from some 30 or more world ports. The most important route is that which connects western Europe with the north Atlantic ports of America. Over this line normally flows more than one-sixth of the world's en-

tire commerce, embracing a great variety of goods. Ships from England carry chiefly manufactured articles, textiles, and a wide assortment of goods originating from many other countries. London has long been the principal *entrepôt* of the world—a center from which goods imported are reexported on an extensive scale. Shipments from France consist largely of wines, silks, lace, jewelry, perfumes, and other goods of a fancy or luxury character, as well as some staple manufactures. From Germany come musical instruments, toys, cameras, scientific and optical instruments, chemicals, and textiles.

From the United States to Europe flow cotton, wheat, meat, petroleum products, metals, machinery, lumber, automobiles, and manufactures of all kinds.

A second major trade route proceeds from western Europe to the Panama Canal, whence it branches off to the Pacific ports of North America, to those of South America, and to Australia. Cargoes from Europe are much the same as those described above. Returning from the Pacific ports of South America, ships carry chiefly minerals, such as nitrates, copper, tin, lead, zinc, and oil; and tropical products—cacao, sugar, quinine bark, tanning materials, and some cotton and rubber.

A third route, that connecting Europe with eastern South America, is also one of importance. European products are transported along this route in exchange for coffee from Brazil and meat, grain, hides, and wool from Argentina.

A fourth and much traveled European route leads eastward along the Mediterranean and through the Suez Canal to India, Ceylon, the East Indies, and the Far East. European shipments to these regions are traded for rice, wheat, cotton, sugar, and jute from India; tea and graphite from Ceylon; rubber, tin, and copra from the Malay States; wool, meat, grain from Australia; silk, tea, and textiles from Japan and China.

A fifth European route proceeds from western Europe, particularly England, down along the western coast of Africa to Cape Town. The chief West African and South African products which return along this route are minerals, especially chromite, copper, gold, and diamonds; and tropical products, such as cacao, mahogany, ebony, and ivory.

Turning to the trade routes which center in the United States, the most important is the North Atlantic route to Europe, already discussed. This route claims over half the tonnage which enters and leaves American ports. Other important Atlantic routes connect New York with Cuba and the West Indies, with eastern South America, with Central America, and, through the Panama Canal, with western North America, western South America, and the Far East.<sup>4</sup>

New York is far in the lead of other American ports, with foreign tonnage five or six times that of Boston and Philadelphia combined. New York ordinarily handles more than 30% of American foreign trade. In the South Atlantic region, Baltimore leads, with Charleston and Savannah also playing fairly important rôles. Galveston and New Orleans are the two important Gulf ports, and are about equal in volume of tonnage cleared.

Commerce in the Pacific region has been growing rapidly. From San Francisco, Los Angeles, and Seattle, trade lines extend to Yokohama, Shanghai, and Manila, and to Sydney by way of Honolulu. From these American ports flow manufactures, lumber, metals, and cotton; from China and Japan come silk and textiles: from the Philippines, coconut oil, copra, and sugar. Wool is the principal export from Australia.

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<sup>4</sup> The United States Maritime Commission lists 23 trade routes from American ports. *Economy Survey of the American Merchant Marine*, 1937.



PART II

THEORETICAL FOUNDATIONS





## CHAPTER 6

### FOREIGN EXCHANGE RATES AND THE MECHANISM OF PAYMENT

**The Rate of Exchange.**—In practically every nation the monetary unit used for buying and selling differs from that used in other nations. In a few instances the units appear to be similar, as in the case of the United States and Canada; but the Canadian dollar and the American dollar are not the same.

In Great Britain the currency unit is the pound sterling, divided into 20 shillings, or 240 pence. The currency of Great Britain, it will be noticed, is not based upon the decimal system. One penny is the equivalent of about two cents of American money, and 12 pence make 1 shilling, or about 24 cents of American money. The guinea consists of 21 shillings or one shilling more than a pound, but is not used extensively any more. The smallest denomination in Great Britain is the farthing, worth one-quarter of a penny. The symbols of British money for pounds, shillings, and pence are £, s, and d, so that 2 pounds, 5 shillings, and 6 pence would be written £2 5s 6d. In France the unit is the franc, divided into 100 centimes, and in Germany the mark, divided into 100 pfennigs. Wherever we go, from China to Europe, to South Africa, we find different units, although sometimes similar names are used.

In all countries there are people who are continually wanting to convert some of their own money into that of another country. For example, Mr. A in New York wishes to send money to his mother who is in England. He has \$1,000 to remit, but he knows that his mother must have pounds, not dollars, since the pound is the currency of her country. He is, therefore, ready to offer to exchange American dollars for British pounds. He knows from experience that it will take about \$4 to buy one British pound, which means that he will

get only about £250 for his \$1,000. He knows, however, that the pound will buy many more goods in England than the dollar will buy in America, perhaps four times as many, so he regards the bargain as reasonable. He knows also that the cost to him in pounds changes from time to time. Early in 1933 he had to pay only \$3.50 for a pound, while later that same year he found it necessary to pay \$5.50 for each pound.

The price of one currency in terms of another is known as the rate of exchange between the two. Thus, the rate of exchange in New York on London might be \$4, \$3.70, or whatever amount of American money was required to buy £1. Sometimes the rate is quoted as the number of foreign units which can be bought with the domestic unit. Thus, in London the rate on New York always refers to the number of dollars to the pound rather than the cost in pounds of \$1. A rate of 4.20 therefore means that \$4.20 can be obtained for £1. In most Latin American countries this same system of quoting dollars prevails. Before the first World War, German marks were always quoted in New York as the number of marks to the dollar, so that the mark, instead of being quoted as about 24 cents, was quoted at a fraction over 4. Note that a rate for pounds of 4.20 means a rise in the price of dollars as compared with a rate of 4.50, since at 4.20 fewer dollars are received for each pound. Note, therefore, that in London exchange rates on New York may be said to have risen from 4.50 to 4.20, or to have fallen from 4.20 to 4.25. This does not apply in New York, where a change from 4.50 to 4.20 means a fall, in that pounds are cheaper in terms of dollars.

**Banks as Intermediaries.**—At the same time that Mr. A in New York is offering to sell his dollars in exchange for pounds, Mr. B, also in New York, is the owner of pounds in London. He has sold some goods to persons in Great Britain and has deposited the proceeds from the sale to his credit in a London bank, or he has a draft payable in pounds to his order. If he and Mr. A should happen to get together, he could sell his pounds to Mr. A, and thereby receive American dollars which he would like to have.

Mr. A, however, may not want the exact number of pounds which Mr. B possesses, nor at the time that they are available. In order to facilitate matters, a bank or foreign exchange banker comes into the picture and serves as an intermediary. The bank buys the London pounds from Mr. B and from others who are in possession of pounds and who wish to convert them into dollars, and then turns around and sells the pounds to Mr. A and to others who wish to buy pounds and pay dollars. The bank makes a profit on the transaction in that its buying and selling rates are not identical. It buys the pounds for slightly less than it sells them.

In America, as in all countries, there is at any one moment a large number of people desirous of buying pounds (also other foreign currencies), and at the same time a large number of people desirous of selling pounds (also other foreign currencies). These latter people have come into possession of the foreign money in various ways and desire to exchange it for money of their own country. The two groups cannot do business with each other directly for practical reasons, so they deal with foreign exchange bankers or with the foreign exchange departments of commercial banks. Banks buy foreign drafts or bills, and are therefore in a position to sell bills payable in whatever foreign currency may be desired. Under the system of exchange control developed prior to the war and now widely adopted, governments control the buying and selling of bills and determine the rates. This subject is discussed in Chapter 29 on Exchange Control.

What Mr. B actually sold to the bank was probably a draft for so many pounds made payable to his order, due on a certain date and drawn on a London bank—a piece of paper not unlike an ordinary American check. The draft was probably for an odd amount and would not exactly suit the needs of Mr. A. The bank thus serves a useful purpose in buying these drafts, depositing them in its foreign account maintained abroad and then selling to other persons drafts on this account in the exact amounts desired and payable to whomsoever desired.

Banks which make a specialty of dealing in foreign exchange keep funds on deposit in the leading financial centers of the

world, and can draw drafts upon these funds payable to whom-ever requested, and at any future time requested, upon demand, 60 days, 90 days, or more from date. As regards smaller centers where the bank does not maintain funds of its own, arrangements are made with other banks providing for the drawing of drafts on these foreign centers. An American bank may keep a deposit in a bank in London, which in turn has funds in many continental and other foreign cities or has relations with banks in these cities. An American bank by various arrangements is enabled to draw drafts on banks all over the world and to sell them to its customers for dollars.

Prior to the inauguration of exchange control systems, banks were ordinarily in active competition with each other, so that the rates which they quoted customers were practically identical at any one time. They were in constant touch with what was happening abroad, and also in their own market. They knew what rates were prevailing abroad and also what other banks in their country were charging. Thus, the rates in New York on London, Paris, or other cities differed but slightly from bank to bank. Regulation of foreign exchange dealings by governments altered this system in that rates are now usually officially fixed and in most countries the purchase of a bill requires a license.

**Supply of Bills.**—The question arises as to what determines in a free market the rates between dollars and pounds, dollars and francs, or dollars and other currencies. Why does the pound cost about \$4 instead of \$10, \$20, or \$2? In the absence of regulation, why do the rates fluctuate from time to time, and what determines the rates between pounds, francs, marks, lire, pesos, and the various other foreign currencies?

The rate of exchange which a New York bank charges, assuming a free market, for a particular foreign currency is determined immediately by the demand and supply in New York for that particular currency. If the supply of pounds coming on the market is large, foreign exchange bankers will reduce the price they offer for pounds. Similarly, the price which they charge for the sale of pounds will be less, so that they will be

able to dispose of the pounds which they are buying. For example, if pounds were quoted at \$4.87, and a heavy offering of pounds took place, perhaps because of financial disturbances in London or of exports to London, the increase in the supply offered in New York would tend to push the rate down toward \$4.86 or \$4.85. On the other hand, if the demand in New York for pounds increased, perhaps because of financial uncertainties in America and the desire of persons here to send their money abroad, or because of imports from London, the price of pounds would tend to rise toward \$4.86 or \$4.87.

In other words, the rate of exchange which prevails in the market at any one time, under a free system, is merely the price which will equilibrate demand and supply. The principle involved is fundamentally the same as that involved in the determination of the price of anything else. This, however, is only a surface explanation and does not take us very far. The real question is, What makes the supply what it is, and the demand what it is, and why do these change? The answer to this question is not simple. It is dealt with in sections and chapters which follow.

The supply of foreign drafts comes from many sources. Persons and businesses come into possession of foreign money in a variety of ways. First, we have the American exporter who perhaps has sold a shipment of cotton to a British firm in Manchester. As a result of the sale, he is entitled to draw a draft on the British importing firm, or perhaps upon the importer's bank for £1,000 which is due him. He may have received a letter of credit sent him from London showing his authority to draw such a draft against the cotton exported. In any event, he takes the pound draft which he has drawn to his bank which buys it and credits his account with American dollars, \$4,000 we will assume. In the event that the draft should not be paid in London, the American bank which bought it would, of course, look to its customer, the exporter of the cotton, for reimbursement.

Note that the exporter of the cotton has, as a result of the shipment, brought into existence a supply of pounds available for sale on the American market. The pounds are bought by the American bank, deposited to its account in London, or

perhaps to the London account of some other American bank in the event that the first bank has no account in London, and are available for sale to anyone in America desiring such foreign currency. Thus, exports of merchandise create a supply of foreign bills.

Another source of supply of foreign bills is from American companies which render various services to foreigners, shipping companies, banks, legal firms, or moving picture companies which receive royalties from American films exhibited abroad. The types of services rendered to foreigners by Americans are numerous, and place the American rendering the services in possession of foreign money; this money is then offered to banks in exchange for American dollars.

Foreign travelers visiting in America need dollars for expenses. They go to American banks and present drafts on their foreign banks, or letters of credit entitling them to draw drafts on such banks, and ask for American currency. Such transactions provide another source of foreign bills for American banks.

Foreigners who owe interest on money previously borrowed from Americans also provide a source of foreign bills. The foreign borrowers remit to the American creditors, who own foreign bonds, drafts to provide interest due or to repay principal due. The American creditors thereupon offer the foreign currency to their banks in exchange for American dollars. In actual practice the foreign borrower's bank may remit the money due directly to some American bank or financial institution which acts as agent. The American bank may handle the entire conversion into dollars on behalf of the foreigner and send dollars, not pounds or francs, to the American creditors. This is the customary procedure as regards the many foreign bonds sold in this country during the twenties and on which interest and principal are payable regularly in American dollars. The American purchasers of the bonds prefer to know exactly how much they are going to receive in their own money, and they do not care to bother with foreign drafts.

Another source of supply of foreign funds is found in the influx into this country of foreign capital for safekeeping,

investment, or speculation in the United States. Such investment must take place in terms of American dollars so that the foreigners, in effect, offer to an American bank their own currency to be exchanged for dollars.

Many other sources of foreign bills of exchange exist, but the above transactions account for the great bulk of foreign money offered for sale in the United States. The total amount of such foreign money offered in 1939 was the equivalent of about \$8,803,000,000.

**Demand for Bills.**—Turning to the demand side, we find that the demand for foreign funds comes also from a great variety of sources, which are largely the reverse of those above. The largest single demand for foreign bills is from American importers of foreign merchandise. They are required to make payments to foreigners, and therefore desire foreign funds. Then we have the demands of American travelers abroad who need foreign money to pay traveling and other expenses. Some of this money is purchased prior to sailing, but the larger part of it is obtained in the foreign country. Americans abroad draw drafts against their letters of credit and offer the dollar drafts to foreign banks in exchange for the needed local currency.

It will be noted that the sources of supply and demand for foreign funds coincide with the credit and debit items respectively in the balance sheet of international payments, discussed in the next chapter. The export of merchandise, and services rendered, which are credit or receipt items, provide Americans with foreign funds, while an import or services received, which are debit or payment items, create a need or demand in America for foreign funds.

Factors which cause changes in the amounts demanded, or the amounts supplied, involve fundamental economic and financial forces. They have to do with such things as technological changes, basic shifts in demand, price level movements, tariffs, internal financial policies, and political conditions. These economic and financial matters have many ramifications and are basic in their influence upon the demand and supply of bills, and therefore upon exchange rates. These are discussed below, but

it should be noted here that a mere enumeration of the sources of demand and supply does not completely explain exchange rates.

**Par of Exchange; Gold Export and Import Points.**—The expression “par of exchange” applies only between countries having a fixed metallic content for their currency units. Thus the United States dollar contains approximately 13.71 grains of pure gold. Until January, 1934 the dollar was defined as 23.22 grains of gold 1,000 fine. The fineness or quality of metal in money is expressed in terms of thousands, so that if a coin has 10% alloy and 90% pure metal, it will be shown as .900 fine. In Great Britain the former pound sterling contained about 79.88 grains of gold .916 $\frac{2}{3}$  fine; the gold standard based upon this unit was abandoned in September, 1931.

For the sake of simplicity let us assume we are back in the first part of 1931 and ignore for the moment the currency changes since then. By arithmetic we find that the pound sterling contained 4.8665 times the amount of pure gold of the American dollar as it then existed. The rate, therefore, of 4.8665 was the par of exchange between pounds and American dollars, as both currencies were then constituted. It meant that the gold pound weighed nearly five times as much as the gold dollar.

The 1914 French franc contained about  $\frac{1}{5}$  the gold of the American dollar, so that the par between francs and dollars was at that time 19.29 cents per franc. The gold content of the franc was reduced formally in 1928, so that the franc then contained only about  $\frac{1}{25}$  as much gold as the dollar, and the new par was thus about 3.92 cents per franc. In January, 1934, the gold in the American dollar was reduced to 59.06% of its previous amount, so that the par with France became about 6.63 cents per franc. In October, 1936, the franc was again devalued to bring it into line with the pound and dollar. The franc became worth about 3 cents, but was not given a precise gold content. Then came the war and the cessation of quotations.

No country today is on the gold standard as this standard was formerly understood, so that the par of exchange between



currencies does not have its previous significance. Formerly, between countries which had the gold standard—that is, countries which permitted the free flow of gold in and out of the country and redeemed their currency in gold at fixed rates—par played an important rôle. Par was the point around which market exchange rates tended to become stabilized. Rates of exchange in such cases could not depart very far from par. The reason for this is simple, namely, no one would pay much more than par for a foreign currency since domestic gold could be exported to that country and converted into money there at par. The desired foreign money could thus be obtained at a cost represented by par plus expenses of shipping the gold.

An illustration will make this clear. When the United States and Great Britain were both on the gold standard in 1931, if a person desired a draft on London and his New York bank quoted a price of \$4.90 per pound whereas par was about 4.86, he could ship American gold to London and when it arrived present it at the Bank of England and receive pounds at the rate of one pound for every \$4.86 of American gold. If gold coins were sent they would be accepted by weight, so that if they were worn they might not yield quite the full face value. Gold bars are shipped in international trade more extensively than are coins. The cost of shipping the gold, including insurance, loss of interest, transportation, and other costs would be less than 2 cents per pound sterling. Therefore the bank could not collect a premium above par greater than this cost of shipping gold. This point above par at which it paid to export gold was known as the gold export point. Under normal conditions it was the maximum rate which could prevail for a foreign currency.

The gold import point is the reverse of this. If a person had a pound draft for sale and his bank should offer to buy it at a rate, for example, of \$4.82 per pound, the owner of the draft could more economically import British gold. For each pound imported he would receive \$4.8665 of American money. The gold import point thus placed a lower limit on exchange rate fluctuations. Prior to September, 1931, market fluctuations between dollars and pounds were held between the narrow limits fixed by the gold export and gold import points; so that the

rates did not go much below \$4.85 nor rise much above \$4.88.

Private persons, of course, seldom engaged in the shipment of gold. These operations were commonly carried on by the large banks when they could see a chance for a profit. When the United States and Great Britain were both upon gold, if the demand in New York for London funds became strong and the rate tended to rise above 4.88, a New York bank might ship American gold to London since this might be the cheapest way to replenish its supply of pounds. Drafts could then be sold by the bank against the gold shipped.

Exchange rates needed to rise only fractionally above the cost of shipping gold for banks to engage in the export and import of gold. Banks were on the alert for profit and any profit, no matter how small, was worth the effort, since the costs of the transaction could be figured fairly accurately. As soon as the gold was shipped, or even prior to shipment, a bank could sell drafts against it. As a result of currency changes of recent years, the gold points today have little practical significance.

**Exchange Rate Fluctuations.**—When the stabilizing influence of gold movements no longer exists, the rate prevailing in the market is a demand and supply rate with no limits on either side, except those exercised by control devices. Market fluctuations may be wide. Thus, when Great Britain went off the gold standard in September, 1931, the pound sterling dropped sharply and by late 1932 was as low as \$3.14. Had it been possible to export gold from Great Britain, no American owner of a British draft would have accepted such a low price. Instead he would have imported gold and received \$4.86 for each sovereign of British gold. As a result of weakened confidence in the pound, the offerings of pounds were so heavy that a low rate was required in order to find buyers for the drafts.

After the United States left gold in 1933, the rates on London rose and reached \$5.52 by the latter part of that year. This rise in sterling was partly because foreigners were afraid of the American dollar, and there was a consequent heavy offering of American dollar drafts abroad as foreigners sought

to withdraw funds from the United States. From the standpoint of the New York market, there was a strong demand in New York for foreign drafts to remit to foreign owners of American funds. Americans were also nervous about the dollar, and accordingly sent their money abroad. This procedure, similarly, involved an increased demand for foreign bills. From whichever side of the Atlantic the matter be viewed, the condition was one of a large offering of dollars against pounds and other foreign currencies, so that prices for pounds and other units rose in terms of dollars.

Since the abandonment of the gold standard and the steady-ing effects of gold movements, which tended to hold market rates close to par, governments, or their central banks, have endeavored to maintain rates fairly stable by various control devices. This procedure has been developing since the first World War, and particularly during the few years prior to the second World War. To stabilize rates the government may enter the market either as a buyer or seller of bills, and by large sales or purchases influence the rates. In order to be able to sell foreign drafts, the government, or some agency of the government, must maintain balances abroad. Or, if the government has a gold reserve, it may export gold. This enables the government to sell foreign drafts if exchange rates rise higher than the government desires. If the rates, on the other hand, decline, the government can buy foreign bills paying out domestic funds, and thereby absorb the surplus bills from the market. Large so-called stabilization funds have been established for this purpose by Great Britain, the United States, and other countries. This question is discussed further in later chapters.

Stabilization operations of this type have to a large extent been superseded by, or have developed into, what is known as exchange control. According to exchange control, a license is required to purchase bills of exchange. Since licenses are issued only for certain purposes, this amounts to a system of rationing the supply of foreign money. The rates of exchange are officially fixed, and usually at levels lower than those required to equilibrate demand and supply. A shortage of foreign money therefore exists, in view of the low rates, and licensing becomes

necessary. The purchase and sale of bills is usually centralized in a governmental agency.

An increasing number of restrictive devices upon exchange operations were employed as the depression, beginning in 1929, and the subsequent currency disorders unsettled exchange rates. The effects of these upon the volume of foreign trade has in most cases been repressive and unhealthy, although under war conditions such measures are undoubtedly necessary. However, they cause exchange rates to be artificial and not to reflect the basic demand and supply situation regarding bills. Moreover, they usually bring into existence a so-called bootleg market where bills are bought and sold secretly at varying rates. When a currency tends to depreciate, the issuing of regulations prohibiting the buying or selling of foreign bills, except at certain rates, does not solve the problem, although it may meet an emergency situation.

Of a different nature are stabilization efforts which recognize fundamental economic trends, and which aim to iron out the short-time ups and downs of rate fluctuations. Such efforts ordinarily do not involve restrictions upon the free purchase and sale of bills, but approach the problem through endeavoring to increase the supply of foreign exchange or through absorbing surplus offerings, according to the requirements of the situation.

Table 9 shows the principal foreign currency units and their values. When we speak of a rate for a certain currency, we must specify several details if we wish to be exact. Thus the rate at which a bank will buy a foreign bill is different from the rate at which it will sell such a bill. The length of time the bill has to run also influences the price, a demand or sight bill being more desirable and costing more than a 60-day or 90-day bill. The rates also change during the course of a day. The rates in this table are averages based upon daily quotations of noon buying rates for cable transfers in New York City.

**Foreign Exchange Methods.**—In the previous illustration, it was assumed that the American exporter of cotton drew a draft

on the British importer (or on the importer's bank), and that he then sold the draft for dollars to his own bank in America. This is one method, but several variations are possible, according to the arrangements that have been agreed upon. The American exporter, instead of drawing a draft in pounds, may be sent a draft on an American bank payable in dollars, purchased by the British importer of the cotton who paid for the draft with pounds. Another method would be for the British importer to send to America a draft on London payable in pounds, although this method is unlikely. This would necessitate the selling of the draft for dollars by the American exporter. Whatever method is used, the draft might be payable at sight or at some future time. Custom determines to a considerable extent what particular method is followed. Whatever method of payment is used, there is involved, it will be noted, payment by someone in Great Britain to someone in the United States, which means the offering of pounds in exchange for dollars.

From the standpoint of the demand and supply of bills, London and New York may be viewed as two parts of the same market. In the first illustration, when the American cotton exporter draws a bill on London and sells it to his bank, an American bank receives pounds (which it can subsequently sell), and pays out dollars. If, on the other hand, the British importer goes to his London bank and buys a dollar draft on a New York bank, the transaction is fundamentally the same, the New York bank pays dollars and receives pounds. In both instances an American bank pays out dollars and is reimbursed with pounds. Thus there is in each case an offering of pounds against dollars.

It is sometimes wondered why rates between pounds and dollars are always practically the same in London as they are in New York. If in New York the rate for pounds falls from \$4.95 to \$4.90, the rate in London moves in the same manner at the same time, so that the two rates are always practically identical. The reason for the similarity in rates between New York and London is that these cities are in reality two parts of the same market.

TABLE 9. FOREIGN EXCHANGE RATES  
(In dollars per unit of foreign currency)

Country	Unit	Type of Exchange	Date	Rate
Argentina**.....	peso	Official A	7/16/42	\$ .2680
		Official B	7/16/42	.2364
		Bid	7/14/42	{ .2024
				.2020
		Free market	7/16/42	.2359
Australia*.....	pound	Free	7/31/42	3.2150
		Official	7/31/42	3.2280
Belgium*.....	belga	Official	1940b	.1688
Bolivia**.....	boliviano	Controlled	4/16/42	.0215
		Curb	4/1/42	.0203
Brazil**.....	milreis	Officiala	4/19/42	.0606
		Free market	4/19/42	.0508
		Special free market	4/19/42	.0487
		Curb	4/4/42	.0506
Bulgaria*.....	lev	Official	1939b	.0121
Canada*.....	dollar	Official	7/31/42	.9091
		Official	7/31/42	.8988
Chile**.....	peso	Official	4/11/42	.0516
		Export draft	4/11/42	.0400
		Curb market	4/11/42	.0333
		Free	4/11/42	.0321
		Gold Exchange	4/11/42	.0321
		Mining dollar	4/11/42	.0321
		Agricultural dollar	4/11/42	.0321
China*.....	yuan	Official	July, 1941	.0524
Colombia**.....	peso	Controlled	3/31/42	.5714
		Bank of Republic	3/31/42	.5698
		Stabilization fund		
		Class 2 merchandise		.5571
		Class 3 merchandise		.5347
		Class 4 merchandise		.5128
		Curb	3/31/42	.5586
Costa Rica**.....	colon	Uncontrolled	4/30/42	.1721
		Controlled	4/30/42	.1779
Cuba**.....	peso	Free	Sept., 1942	1.00
Czechoslovakia*...	koruna	Official	1939b	.0342
Denmark*.....	krone	Official	1940b	.1931
Dominican Republic**.....	peso	Free	Sept., 1942	1.00
Ecuador**.....	sucre	Central Bank (Official)	5/1/42	.0709
Egypt*.....	Egyptian			
	pound	Official	1939	4.5463 <sup>c</sup>
Finland*.....	markka	Official	June, 1941	.0201
France*.....	franc	Official	1940b	.0208
French Indo-China*	piaster	Official	1939	.2510 <sup>d</sup>
Germany*.....	reichsmark	Official	June, 1941	.3997

Country	Unit	Type of Exchange	Date	Rate
Greece*	drachma	Official	1940 <sup>b</sup>	\$ .067
Guatemala**	quetzal	Free	Sept., 1942	1.00
Haiti**	gourde	Free	Sept., 1942	.20
Honduras**	lempira	Official	4/25/42	.4901
Hong Kong*	dollar	Official	December, 1941	.2504
Hungary*	pengo	Official	1941 <sup>b</sup>	.1977
India*	rupee	Official	7/31/42	.3012
Italy*	lira	Official	June, 1941	.0526
Japan*	yen	Official	July, 1941	.2343
Mexico**	peso	Free	4/18/42	.2057
Netherlands*	guilder	Official	1940 <sup>b</sup>	.5312
New Zealand*	pound	Official	5/8/42	3.2278
Nicaragua**	cordoba	Official	5/2/42	.20
		Curb	5/2/42	.1841
Norway*	krone	Official	1940 <sup>b</sup>	.2270
Panama**	balboa	Free	Sept., 1942	1.00
Paraguay**	peso	Official	4/18/42	.003
Peru**	sol	Free	4/18/42	.1538
Poland*	zloty	Official	1939 <sup>f</sup>	.1884
Portugal*	escudo	Official	June, 1941	.0400
Rumania*	leu	Official	1940 <sup>b</sup>	.069
Salvador**	colon	Free	4/18/42	.4000
Spain*	peseta	Official	June, 1941	.0913
Straits Settlements*	dollar		February, 1942	.4671
Sweden*	krona	Official	June, 1941	.2383
Switzerland*	franc	Official	June, 1941	.2320
Turkey*	Turkish pound	Official	1939	.8024
Union of S. Africa*	pound	Official	5/8/42	3.9800
United Kingdom*	pound	Official	August, 1942	4.0350
		Free	August, 1942	4.0350
U. S. S. R.*	ruble	Official	1942	.1887 <sup>e</sup>
Uruguay**	peso	Controlled	4/25/42	.5265
		Free	4/25/42	.5263
Venezuela**	bolivar	Controlled	4/18/42	.2985
		Free	4/18/42	.2824
Yugoslavia*	dinar	Official	1941 <sup>b</sup>	.0223

<sup>a</sup> For commitments of the government only.

<sup>b</sup> Average of daily rates for that part of the year during which quotations were available.

<sup>c</sup> Based on average for pound sterling.

<sup>d</sup> Based on average for French franc.

<sup>e</sup> For foreign-trade valuation purposes only.

<sup>f</sup> Average for first eight months only.

\*Averages of certified noon buying rates in New York for cable transfers. Reported by Federal Reserve Board.

\*\* Average selling rates in foreign country for sight drafts on New York. Compiled by the United States Department of Commerce.

Note: Exchange that is known as "free" is not always free in the sense that unlimited amounts can be bought and sold regardless of the purpose for which the exchange is to be used. Countries that have free rates in this full sense are: Costa Rica, Cuba, Dominican Republic, Guatemala, Haiti, Mexico, Panama, Peru, Salvador, Venezuela, and the United States.

Assume for the moment that the rates were different, that the rate in New York was \$4.90 while that in London was \$5. Americans could then purchase a cable draft for \$4.90 and with the pounds proceeds immediately buy in London a cable draft on New York yielding \$5. This would mean making 10 cents on each pound less minor expenses. It would be a handsome profit. Such transactions would require only a few moments to be completed, and would create so strong a demand in New York for pounds that the rate there would rise from \$4.90 toward \$5. In London the strong demand for dollars would tend to raise the rates from \$5 toward \$4.90. These forces would continue until the rates in the two centers became so close that the profit disappeared. If the rates become separated by only a fraction of a point, transactions such as the above take place, under ordinary conditions, and quickly tend to bring the rates together.

Large sums are being transferred constantly between the various parts of the world by means of telegraph. If a person in New York desires to make immediate payment to a person or corporation in London, he pays dollars to his bank in New York, which cables its correspondent in London to pay pounds to whomsoever he has designated as the recipient. A London exporter having received a cable transfer from New York proceeds with the shipment of goods. He perhaps receives payment from the London bank against delivery to it of shipping documents, which are then forwarded to the New York importer. This would be a cash transaction without credit entering into it, and is not the customary procedure.

Cable transfers are used very extensively, although as a result of the war their sale is restricted. Ignoring for the moment war changes, a New York bank may cable Shanghai to pay Chinese dollars to a tea exporter, or may cable Calcutta to pay rupees to an exporter of hemp. An American importer may have agreed to place a London bank in possession of pounds on a certain day to provide for a draft drawn on the bank by the British exporter and accepted by the London bank, and which is now coming due. The American thereupon buys a cable transfer to cover the draft. An American importer may



find a cable transfer the most economical method of making payment to a London exporter. A cable does not require that he put up any money until the day the payment is due; whereas, if he purchased a demand draft and sent it to London, he would have had to part with his money several days earlier, perhaps borrowing it from an American bank and paying interest. The demand draft would have cost a little less than the cable.

The slightly greater cost of a cable transfer over a demand bill is not due to the expense of cabling, which is usually a very minor percentage of the total cost, but is principally because of the time element and the interest involved. If a bank sells a demand bill, no money has to be paid on it while it is in transit and until it is presented; a cable must be paid immediately. In the case of a demand draft, the bank thus has the use of the money for a longer period than if it sells a cable. For similar reasons a 60-day bill is cheaper than a demand bill, and a 90-day bill is cheaper than a 60-day bill. The reason is the same, namely, no money need be paid on these time bills until they mature; the money is future money and therefore the price of the draft involves a time discount.

The different financial centers of the world normally keep in constant touch with each other. The foreign exchange banker is continually receiving information on events and rates prevailing in the various markets. This information on rates in foreign centers makes possible what are known as arbitrage transactions. Such transactions tend to keep the rates in all foreign centers in line with each other. An arbitrage transaction involves buying a draft on a foreign market, which is to be used there to buy in turn another draft on a different foreign market. For example, assume that in New York a strong demand exists for pounds, so that the rate on London is high. At the same time the foreign exchange banker notices perhaps that francs are cheap in New York, and that in Paris pounds are cheap in terms of francs. In order to buy pounds, he thereupon purchases francs and instructs his Paris correspondent to buy pounds with the francs. He buys pounds via Paris. In New York he may immediately sell a pound draft against the francs purchased to acquire sterling. The transac-

tion of buying sterling via Paris might also include Berlin or other centers. German marks could be acquired via Paris, Rotterdam, or Brussels, or francs via Copenhagen.

If the rate in New York on London should be even slightly out of line with the rate in London on New York, New York bankers would buy pounds and promptly use the pounds to buy in London drafts on New York. Thus they would come out of the transaction with more dollars than they had when they started. This assumes that in London dollars were too cheap in view of the price of pounds in New York. This would be an arbitrage transaction.

Exchange rates are subject to seasonal fluctuations. Thus, in the fall of the year when American cotton and other agricultural crops are being exported, a large supply of foreign bills drawn against these exports exists and has a tendency to result in a decline in the rates, unless other influences offset this. Seasonal fluctuations in rates are tending to be ironed out since foreign exchange operators anticipate them.

The changes in foreign exchange procedure that have been instituted as a result of the widespread adoption of exchange control are discussed in Chapter 29 on Exchange Control.

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**SILVER EXCHANGES.**—Since China abandoned the silver standard in November, 1935, this standard no longer exists in any nation. Exchange rates upon silver standard countries, therefore, have only historical interest. The silver standard, however, has had a long and significant history. Between two silver standard countries exchange rates would be determined by the same principles that determined rates between two gold countries.

Between a gold standard and a silver standard country, exchange rates would tend to be fixed by the price of silver, that is, the price of silver in terms of gold money. Thus, if silver could be bought in New York for 40 cents an ounce, and this silver when shipped to China could be turned into Chinese money at the rate of about 1.25 Chinese dollars per ounce, current exchange rates on Shanghai would be limited by the possibility of buying silver and exporting it

to China. Rates on Shanghai, therefore, could not rise much above the point fixed by the price of silver in New York.

On the other hand, since Chinese silver could be brought to America and sold, rates on Shanghai could not fall below the amount of American money yielded by the importation of Chinese silver. A person in the United States wishing to buy Chinese dollars could always buy silver and export it. Similarly, a person in the United States wishing to sell a Chinese draft could always import silver from China and sell it in America if market exchange rates were out of line with the price of silver.

For example, if a Chinese importer of American piece goods desired to purchase a draft on New York and thought the price of United States dollars too high, he might, if he wished, ship silver to the United States, and sell the silver as bullion. The metal which he shipped would, in the United States, be merely a commodity and would yield a varying amount of United States dollars depending upon the price of silver. Bullion shipments are ordinarily undertaken by banks rather than by individuals. It can be seen that between gold standard and silver standard countries exchange rates had no fixed relationship but fluctuated around a point determined by the price of silver.

Exchange rates between a silver standard country and countries with managed currencies would be determined not very differently from those above. The possibility of shipping silver between these countries would still limit the rates, but the price of silver to be considered would be, not the price in terms of gold, but in terms of the currency of the non-gold-standard country.

## CHAPTER 7

### THE BALANCE OF INTERNATIONAL PAYMENTS

**Trade Two-Sided: Giving and Receiving.**—As discussed in Chapter 1, trading means giving something, and in return receiving something else in exchange. Trade is essentially bartering one article for another article, each article paying for the other. Trade has a dual nature, often concealed by our complicated exchange mechanism involving money, credit, and numerous intermediaries to a transaction—wholesalers, jobbers, commission merchants, retailers, and more recently governments themselves. A seller may never see his buyer face to face. In spite of our modern exchange machinery, trade is merely giving and receiving.

This is true of international trade as well as domestic trade. The exports of a country are given in exchange and pay for the imports, and vice versa. This simple nature of trade has often been misunderstood, and it has been assumed that nations can have large exports without importing from abroad, or vice versa. In a trade between two individuals, as when one boy swaps his knife for another boy's top, the real nature of the trade is clear. The boy who gets the knife pays for it with his top, and the boy who receives the top pays for the top by parting with his knife. Furthermore, the knife is worth more to the boy who receives it than the top he gives up, otherwise he would not be willing to make the trade. Similarly, the top is worth more to the boy who receives it than the knife which he gives up. Both parties to the transaction thus benefit, or think they do at the time of the trade.

In the modern world, trade usually takes the form of buying and selling for money. One of the traders, called the seller, instead of taking a commodity in exchange accepts money, since

the buyer may not have a commodity which the seller wants and which is of similar value. By the use of money the seller is permitted to go out and find a commodity or service which he wants. Money is thus a useful medium of exchange, and while it alters the outward appearance of trade, it does not change the fundamental nature of the trade. Trade is still two-sided and involves parting with something, a commodity or money, and the receiving of something in return. The commodity is payment for the money just as much as the money is payment for the commodity.

It cannot be emphasized too strongly that trade between nations is on this *quid pro quo* basis. Articles which a nation exports are payment for those which it imports, or for services which it receives, and vice versa. What good would it do a nation to export heavily if it did not receive an equivalent amount of goods or services in return? If we wish to sell abroad, we must also buy from abroad; otherwise the foreigners will not have the wherewithal in our money to purchase our goods.

Payment for goods sold abroad is not always completed immediately in terms of goods imported from abroad; but in the long run the total exports and imports of a nation must equal each other in value. This proposition of equality or balance in foreign trade is sometimes known as the equation of international exchange, or the equation of indebtedness. It means, in broad terms, that what we sell, goods and services, must equal what we buy.

The expression "balance of payments" refers to equality or balance between all payments made abroad and all payments received from abroad. From the standpoint of the balance of payments, exports and imports include more than the physical commodities which move in and out of a country. Many intangible or invisible items, as they are called, involve payments and must also be included. Services rendered to foreigners are similar in nature to exports to foreigners, since the services must be paid for by the foreigners just as though merchandise were sold to them. For example, when Americans ride in British ships, they have received something which must be paid for just as though they had imported commodities from Great

Britain. Shipping services constitute one of the so-called invisible items in the balance sheet discussed below.

This statement of balance, that exports must equal imports, does not mean that the foreign trade of a particular nation must balance with each other nation individually. It does mean, however, that the foreign trade of a nation must balance with all nations combined. For example, the United States buys a large amount of coffee and other articles from Brazil. Brazil, however, finds it to her liking to purchase in Great Britain and other countries, so that the United States buys from Brazil much more than it sells there. At the same time, the exports of the United States to Great Britain and to other countries help to pay for the United States' purchases in Brazil. The trade may be looked upon as triangular. Brazil exports to the United States, the United States to Great Britain, and Great Britain to Brazil. All three countries therefore get paid. In actual practice the trade is not quite so simple. Our triangle becomes a many-sided polygon, and only when the trade of Brazil with all other nations is included will a balance be struck and Brazilian exports equal Brazilian imports. In reality the United States normally exports to Europe, Europe to South America and the Far East, and these latter areas send raw materials to the United States which help to pay for the goods the United States sends to Europe.

According to the doctrines of the mercantilists of some 300 years ago, a state should endeavor to have a balance of exports so that gold and silver would be received in payment.<sup>1</sup> A strong state was supposed to be one that had a large amount of gold and silver. This teaching was traceable in large part to conditions of that time, particularly to the fact that states were continually engaged in armed conflict, and that the state with plenty of treasure was better able to carry on military activities. Gold and silver were therefore regarded as the most important forms of wealth. Accordingly, a nation's industrial and commercial policies should be aimed toward the accumulation of as much of the precious metals as possible. Since a large export

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<sup>1</sup> For a more complete discussion of mercantilism see Chapter 15.

trade tended to bring these metals into the country in payment for the goods sent out, the development of the foreign market was regarded as important. A healthy condition of foreign trade was thus regarded as one in which merchandise exports were in excess of merchandise imports, so that the difference would have to be made up by the importation of the precious metals.

In order to encourage exports, and to discourage imports, mercantilism taught that tariff duties and other restrictions should be imposed upon the importation of foreign goods. The purchase of goods from foreigners, it was realized, often tended to take treasure out of the country in payment, while the sale of goods to foreigners tended to bring treasure into the country. Export industries, especially manufacturing, were thus to be given bounties and other forms of encouragement. Shipping was to be aided as much as possible, since this stimulated foreign trade.

An excess of merchandise exports was known as a *favorable balance* of trade, while an excess of imports was known as an *unfavorable balance*. This terminology has continued to the present day. It should be clear, however, from what has already been said, that the words favorable and unfavorable signify nothing at all regarding desirability. A large and growing total foreign trade is to be desired for reasons already discussed. An excess of imports or exports does not necessarily indicate conditions which are either desirable or undesirable.

It is unfortunate that better expressions than "favorable balance" and "unfavorable balance" have not been found, and that these terms continue to enjoy such wide usage since they lead to misconceptions. Many popular discussions and press accounts assume that favorable means favorable, and that unfavorable means unfavorable. Great Britain has long had an "unfavorable balance" of trade, the reason being principally that Great Britain has large investments abroad. The rest of the world owes money to Great Britain and has been paying interest—not a particularly unhealthy condition from the standpoint of Great Britain. On the other hand, a nation heavily in debt to foreigners and with burdensome interest payments to

make may have a so-called "favorable balance" of trade. In actual fact such excess of exports, a favorable balance, indicates in this case an unfavorable condition.

The only reason that it is possible to have an apparent excess of exports or imports is because certain of the so-called invisible items are left out of consideration, as explained below. When all items are included, excesses disappear and the trade is in balance.

While many of the ideas of the mercantilists seem absurd at the present time, if we could transplant ourselves to their day, these doctrines would appear more practical. A large amount of the imports in those days consisted of spices, silks, and other luxuries. When plenty of cash was a matter of vital importance to a sovereign in a period of incessant conflict, the importation of gold and silver seemed much more worth while than that of nutmeg or cinnamon. In a later chapter it will be seen that an increase in the amount of gold or silver in a country tended merely to raise the level of commodity prices. At all events, it did not materially increase the amount of consumable wealth in the country. It did, however, cause the sovereign to have a large supply of cash. Other policies of the mercantilists also appear in a different light when it is remembered that war was a normal state of affairs and that self-sufficiency and a strong state were much to be desired.

One reason why the expression "favorable balance" continues to be regarded today as indicating favorable conditions is that such a balance may be helpful in preventing the country's currency from depreciating in the foreign exchange markets. It may increase the supply of foreign drafts, as discussed in the previous chapter on Foreign Exchange. It is not, however, the balance but rather the increase in the balance that would be helpful under such conditions.

**Invisible Trade.**—When it is said that a nation has an excess of exports or an excess of imports, reference is usually made only to the merchandise trade—the physical goods which move in or out of a country. Many of the transactions between nations, however, are of an intangible sort, as when a British



steamship company carries goods for an American firm or carries American passengers. The American firm has received a service from a foreign company and owes the foreigner just as though the foreigner had sent over physical commodities. The effect of the shipping service to an American firm or to American passengers is to increase the total amount of payments which people in the United States must make to people in Great Britain, the same as though America had imported British goods. Similarly, if an American tourist enjoys himself in Paris, his food, drink, and entertainment must be paid for by exports from the United States. It makes no difference whether a Dutch cheese is consumed by an American in Amsterdam, or is sent to an American in New York. In either event, the cheese must be paid for by the export of American goods or the rendering of services by Americans.

Services rendered by foreigners to us are often called invisible imports. They must be paid for by us in the same manner as visible imports. Invisible trade refers to all foreign transactions, other than the importation or exportation of physical merchandise, which involve the paying or receiving of money, or which result in the obligation of paying or receiving money, that is, which set up a debtor-creditor relationship.

Whenever the United States imports goods or receives services from abroad we owe someone abroad, or in other words we are the debtor. Whenever we export goods or render services, we are owed by foreigners or are the creditor. Imports mean we must pay "them." Exports mean "they" must pay us. It will be noted that our viewpoint is not whether the combined value of the physical articles, wheat, cotton, automobiles, alarm clocks, and other things that we export is greater than that of the meat, wool, chicle, and other physical things that we import. We are concerned not merely with merchandise movements but with the total amount that we owe to foreigners for whatever reasons, and with the total amount that they owe to us for whatever reasons.

**The International Balance Sheet.**—The amounts owed and owing as a result of foreign trade, of loans, and of other finan-

cial transactions during the year are often set up in the form of a balance sheet as debits and credits. It is perhaps clearer to think of them as dollar receipts and dollar payments. Such a balance sheet is a complete statement of a nation's foreign accounts during the period, showing how much is bought, sold, borrowed, loaned, due for services, or other items. When all items are included, the receipts and payments must, of course, be equal, since a nation cannot continue to receive goods and valuable services from abroad without paying for them in some fashion or arranging to pay for them; nor will a nation render services or ship out its goods without being paid.

Transactions which create indebtedness of persons in the United States to persons in foreign countries, and which therefore involve payments by us abroad, are the so-called debit or payment transactions. They are those transactions which create claims against us. The credit transactions are those which involve payments to us by foreigners. They are called credit or receipt transactions.

### Debit Items

The principal debit or payment items are as follows:

*Importation of Merchandise from Abroad.* The nature of this item is clear. All goods received from abroad, whether cloth from England or pig bristles from Wuchang, must be paid for by us, either by the exportation of other goods, or by the rendering of services by us. They are to be listed on the debit side of the balance sheet and are to be offset by credits of some kind we have created or will create.

*Services Received by American Travelers Abroad.* If an American packs his bag and travels through other parts of the world, the foreigners do not take care of him gratis, as he will soon discover. In his travels he receives various services and consumes foreign commodities. These services rendered to him increase the aggregate indebtedness of Americans to foreigners. They constitute a debit item which is often listed on the balance sheet as tourists' expenditures, or travel expenditures.

*Shipping Services Received.* The ships of Great Britain, Germany, France, Italy, Japan, and other countries ordinarily carry a large portion of our foreign commerce. Before 1914 they carried practically all of it. They also carry many Americans as passengers. While American ships now carry more of our foreign commerce than formerly, shipping services for which foreigners must be paid are an important debit item.

*Remittances of Immigrants in America.* Many foreigners in America remit from their earnings in this country sums of money to relatives and friends in their home countries. An Italian may be supporting his mother in Naples, or he may be storing up money there against his return. Prior to the war such remittances amounted to about \$100,000,000 each year. At first thought it may seem strange that this item is to be listed as a debit. It is true that the people in America who are remitting have not received goods or any specific service for which they are paying. The Italian has not brought over here Italian wine or cheese. The people here do not really owe the money nor are they required to make any payment. They are not in debt to foreigners in the ordinary sense, but the remittances are sent anyway, and thereby make necessary the shipment abroad of American goods or the rendering of services by the United States.

The immigrants are paying foreigners, not because they rode in foreign ships or lived in foreign hotels, but because of sentimental relationships or other reasons. Although the remittance goes out as a gift or is to accumulate a fund in "the old country," it creates indebtedness of America to foreigners which must be provided for by the exportation of American goods, services, or by credits created in other ways.

*Missionary and Charitable Contributions.* These are similar in nature, from the standpoint of the international balance sheet, to the remittances of immigrants, and do not require separate discussion. They represent voluntary payments which we make to foreigners, or to Americans living in foreign countries, such as Red Cross relief, or religious contributions, and are therefore placed alongside other current indebtedness or payment items. In 1940 these sums sent out of the United States amounted to about \$54,000,000.

*Insurance and Banking Services Received.* Many foreign insurance companies insure or reinsure risks for Americans. Particularly is this true in the field of marine insurance, where a large proportion of the premiums which Americans pay go to British insurance companies. Banking and other financial services are also performed for Americans by foreign institutions. The charge for these services is to be listed as a debit or payment item from the American standpoint. From the foreign standpoint these services are credits, as are shipping and other services to Americans.

*Interest and Dividends Paid Foreigners.* A large amount of foreign capital has been invested in the United States. As interest and dividends upon this capital are earned, the United States becomes indebted to the foreign owners of the capital for these amounts. Interest and dividends paid abroad are therefore debits. They represent payments which we are obliged to make, and are to be provided for by merchandise exports, services rendered, and other credits.

*Capital Sent Abroad, or the Importation of Foreign Securities.* Whenever we import foreign stocks, bonds, or other financial obligations we must pay for them. Their importation, it is clear, creates indebtedness upon our part for which we must provide. Once these securities are paid for by us, however, foreigners owe us, since the securities themselves are evidences of debt or represent investments by us abroad which are of a similar nature to debts owed us.

The importation of these securities represents American capital going into foreign countries, either as a loan or as an investment. Such capital exported (securities imported) is to be entered at the time as a debit transaction, since in order to get the capital abroad we must send goods, render services, or make payment in some way. Such payments made to foreigners are not for merchandise imports received by us, nor are they payments for services rendered to us. The payments are for foreign securities which we have received and which are evidences of indebtedness or investment.

American exports can establish credits abroad in our favor which may be left there more or less permanently and which yield us interest, or, it might be added, are expected to do so. Capital

invested abroad thus represents the utilization of credits which have been (or must be) created abroad by the exportation of our goods or by services rendered by us.

The existence of a large amount of accumulated credits owing us, or, in other words, capital or investments abroad, is not to be confused with the process of creating such credits or of receiving repayment of them. Such nations as the United States and Great Britain are so-called creditor nations, meaning that over the years these countries have sent capital abroad and in the net are creditors, being owed more than they owe. Foreign nations also have money invested in America. Current interest and dividend payments by America on this capital are to be entered on the balance sheet (debit side), as are also principal repayments or new capital going abroad. The mere existence of capital abroad, however, is not an item to be shown in a balance sheet of transactions for the year. The accumulated capital itself is not a current transaction, but the interest and annual repayments of principal are items to be entered upon one side or the other, depending upon which way the payments flow.

*Repayment by Americans of Loans Owning Foreigners.* Payments made to extinguish foreign loans to us are also debit items, and are of a similar nature, from the standpoint of the balance sheet, to new capital sent abroad. In both cases payments are made to foreigners, but in the former case the purpose is to repay obligations while in the latter case the purpose is to make new investments. The repayment of foreign loans may be thought of as the importation into America of our own obligations previously exported. To do this means that we must "buy" (repay) these obligations, and pay for them just as though we were paying for merchandise imported. Our own securities imported are thus similar in nature to foreign securities imported or to merchandise imported.

*Miscellaneous Transactions.* The above transactions account for the chief sums paid by a nation during the course of a year, or whatever period is covered by the balance of payments statement. There are, however, numerous smaller transactions which involve additional debtor-creditor relationships between citizens of one country and those of another country. Advertising fees which

American companies owe foreigners amount to several million dollars a year. The importation of electric power into the United States from Canada, telegram and cable services received by us from foreign companies, legal services and patent and copyright purchases and royalties due foreigners, also mean that we owe money abroad.

### Credit Items

The credit or dollar receipt transactions are largely the opposite of the above debit or payment transactions. Credit transactions pay for the debit transactions and consist principally of the following:

*Exports of Merchandise.* Goods sent abroad mean that foreigners owe us; the goods create a credit in our favor.

*Services Rendered by Us.* For these services foreigners must pay us.

*Interest and Dividends Due Us by Foreigners.* These are owed to us because of investments which we have abroad.

*Remittances Home of Americans Earning Money Abroad.* These involve a payment to us even though we have not imported foreign merchandise or received services.

*Foreign Money Sent Here for Investment or Safekeeping.* Such transactions mean that our securities have been exported and that we must therefore be paid, or that our banks have accepted a liability to foreigners, and must therefore be paid. Several billion dollars of foreign money came to America prior to the war to escape the dangers abroad.

*Repayment to America of Money Borrowed.* This extinguishes a debt to us; the process involves current payments to us the same as though new capital were coming in.

*Miscellaneous Transactions.* Motion picture royalties paid American companies from abroad, substantial sums before the war, amounting to about \$110,000,000 in 1936, are to be listed on the credit side of the balance sheet. On the other hand, royalties we paid on foreign films, a debit item, amounted in 1936 to only about

\$6,000,000. Numerous other miscellaneous credit or dollar receipt transactions might be mentioned.

Certain types of transactions, it will be noted, are frequently much more important on one side of the balance sheet than on the other, and also vary greatly from country to country. For example, travel expenditures, missionary contributions, and immigrant remittances are more important in the American balance sheet than in those of other countries. Americans travel more widely than do most foreigners, and also have been more generous in their charitable and religious contributions abroad. Motion picture royalties received are also more important in the American balance sheet than in those of other countries. In the British balance sheet, shipping services rendered constitute an important item.

**International Borrowing and Lending.**—Practically all nations have money loaned or invested in foreign countries. Such investment usually takes the form of loans to foreign individuals, corporations, or governments, or it may involve the outright ownership and active management of some foreign enterprise. Many American corporations have established branches, manufacturing and assembling plants in various parts of the world. Nations such as the United States, Great Britain, France, and some of the others have large amounts of capital invested abroad in one form or another which yield substantial income.

As a nation grows and becomes more highly developed, the tendency has been for interest rates in that country to decline. When interest rates and investment yields at home become low, investors look increasingly to foreign countries for opportunities to place their funds. The development of banking and financial institutions has contributed to the flow of capital out of a country.

Especially in new and undeveloped countries are investment yields usually high. Capital can be put to good usage in such countries in terms of productivity. Tools and equipment add greatly to efficiency where such equipment has been lacking. Thus borrowers can afford to pay high rates for capital in a

country that is relatively undeveloped and deficient in physical equipment. Such investments are ordinarily accompanied with considerable risk, largely because of political uncertainties. Nevertheless, the prospects of good returns make foreign investments attractive to many investors. The experience of the United States with foreign loans, particularly those made during the twenties, has not been very fortunate. This was due largely to mistakes on the part of American investors and to unscrupulous promoters. Great Britain in recent years has fared better in her investments abroad than has the United States.

The flow of capital from country to country has expanded rapidly in recent decades. When conditions in Europe were disturbed shortly after the first World War, conservative investors there, fearful of what might happen in their own country, sent funds to America for investment. America in this way was the recipient of a large amount of European capital. During the period of prosperity and speculation which ended in 1929, money from all over the world flowed into America for speculation on the New York Stock Exchange or for investment in other ways. During the thirties, partly as a result of threatening conditions throughout the world, capital again came to America for refuge.

While money from abroad was coming to America during the nineteen twenties, a much larger amount of American money was going into foreign countries. Enormous quantities of American money were loaned all over the world, especially in Latin America and Europe. Many of these loans were made in excessive amounts and out of proportion to the countries' ability to repay, so that a large portion were soon in default. Many have had to be readjusted and are now paying upon a reduced basis or not at all.

Although the large amounts of foreign capital that came to America in recent years reduced the net creditor position of this country, the United States remains a great creditor nation. Prior to 1914 this country had been a debtor nation, since European countries had for decades invested heavily in American securities, especially in railway securities. American foreign investments are discussed in Chapter 23.



**Creditor Nations.**—A creditor nation is one that has more funds invested in foreign countries than foreign countries have invested in it, so that in the net and on total account it is owed more than it owes. This does not refer to the amounts owed by it or to it as a result of the transactions of any one year. It does not refer to the amounts currently to be paid or received, but refers to the total amounts invested abroad in comparison to foreign money invested in it.

A nation may own a large amount of foreign securities and other obligations, being an important creditor, and yet on current transactions be temporarily a debtor in the sense that it has been buying more abroad than it has been selling, and has more current payments to make than current receipts due it. On the basis of only current transactions there may be a deficit. The current deficit may be met by the exportation of gold, by new borrowing abroad, or by drawing on capital already abroad. The latter procedure means the sale abroad of some of the foreign securities or other assets.

A situation of this type confronted Great Britain during the two World Wars. The sale of foreign securities was undertaken systematically by Great Britain during the first World War to help meet the foreign deficit. Great Britain had been buying large quantities of supplies in America and had not been selling enough to pay for her purchases here. She borrowed in America, but since still more was needed she worked out an arrangement with the British holders of American securities whereby the British Government got possession of these securities and was able to pay for some of the purchases in America by the sale in America of these British-owned American securities. Great Britain also borrowed in America. During the second World War the deficit was met by the disposal of assets and by Lend-Lease aid from the United States Government.

Great Britain for generations has been the leading creditor nation, although her position is now greatly weakened and the United States is probably in the lead. Great Britain has money invested all over the world, within the empire and without the empire, so that she is the recipient regularly of substantial interest and dividend payments. As a result of this income, Great

Britain is able to import foreign merchandise or receive foreign services without being required to export in return. If the rest of the world, for example, owes her annually one billion dollars in interest, she can receive one billion dollars' worth of foreign goods or services, paying for them with the interest due her by foreign countries, and without giving anything of her own in exchange. This helps to explain why Great Britain has long had a so-called "unfavorable balance" of trade, that is, an excess of imports over exports. The fact that Great Britain has a large merchant marine and renders many shipping and other services to foreigners, also helps to account for the excess of visible imports. The interest due her is a credit or receipt item, and is to be thought of as offsetting the importation of merchandise or the receiving of services, which are debit, or payment items.

The excess of exports from the United States during the twenties was due largely to the loaning or investing of American money in foreign countries. Prior to 1914 our excess of exports represented interest payments which we were making to foreigners upon their capital invested here. At that time we were a debtor nation, but money loaned by us during the war changed our position so that by 1918 foreigners owed us more than we owed them. As a creditor nation it is possible that in the future we may have an excess of merchandise imports, although we may, of course, be paid in invisible ways, or may continue to export capital, which seems more probable.

The return to America during the first World War of American securities held by foreign owners, particularly British owners, permitted the repayment by America of obligations owed abroad. To make matters concrete let us suppose that the Union Pacific Railway was indebted to the British owner of a Union Pacific bond and paid him interest regularly, that is, provided him with dollars in the United States, which he could dispose of as he saw fit. Assume that this bond was sold in the New York market and the dollar proceeds of the sale turned over to the British Government and used to pay for American goods sent to Great Britain. The Union Pacific Railway then owed an American rather than a Britisher. The dollars provided by the American purchaser of the bond may be thought

of as going to the American exporter of merchandise or munitions, in payment for what he sent to Great Britain.

**Capital Movements Require Movements of Goods or Services.**—It is to be noted that in order to get the above bond back to America and have it owned by an American, that is, in order to repay the loan from the standpoint of America (but not from that of the railway), the United States had to export merchandise, or render a service of some kind equal to the value of the obligation. The principle involved is that capital is transferred between nations only by the exportation of merchandise, the rendering of services, or the creation of credits in some manner.

The making of new loans or investments thus requires the exportation of merchandise or the doing of something which establishes credits in foreign countries. When Great Britain loaned money in the first instance to America, i.e., when the British investor bought the Union Pacific bond, Great Britain had to transfer capital to us by exporting commodities or services. Great Britain provided pounds sterling which were available to the American borrower to buy British rails or to dispose of the pounds in any way desired. Great Britain, of course, did not have to export rails or merchandise to us directly, but she had to export to some country or serve some country. She could export cloth to Brazil and let Brazil export coffee to the United States. As a matter of fact, the entire world is involved in foreign trade, and a foreign loan may expand trade between many countries. In order to transfer the loan, Great Britain was required to export to some country, and the United States was enabled to receive goods from some country—in fact, had to receive from some country. Great Britain could, of course, have permitted some of her debtors to export goods in her stead and have credited them with the amount of the interest due her. This would have amounted to the reinvestment abroad of some of the interest, or principal, due Great Britain.

The point is that the transfer of capital, that is, the making of new loans, the repaying of old loans, the paying of interest, the making of remittances or the making of gifts, requires the

shipment of goods or the rendering of services. Money is only a means to an end in foreign trade as in domestic trade, and loans are really made and repaid in goods and services. Money itself seldom goes from country to country, except in small amounts as carried by travelers or desired by hoarders, but goods flow back and forth and create title to money in foreign countries. Thus goods provide for the transfer of funds, or the movement of capital.

In foreign loan contracts it has sometimes been stipulated that the money loaned is to be expended in the country granting the loan. It can be seen that such an arrangement is not necessary in order to accomplish this purpose, because the money cannot be spent anywhere else. If American dollars are loaned to a British corporation, the dollars, which are not current in Great Britain, cannot be spent in Great Britain, but must be expended within the United States. If the British borrower desires to purchase at home he must first sell the American dollars for British pounds. The purchaser of the dollars then spends the dollars in America, and may take American goods to Britain or elsewhere. He may, of course, leave the dollars in America as an investment. This is discussed further in Chapter 22.

**Balance of Payments of the United States.**—A study of foreign trade from the standpoint of the balance of payments deals with values rather than with the quantities of goods imported and exported. Quantities have their significance, as explained later, but foreign trade takes place in terms of specified values. It is so many dollars, pounds, francs, or pesos that are owed rather than tons, bushels, or bales. The values at which goods are traded change constantly, but each transaction means that a certain amount of money of some country is paid or is owing. A balance of payments study therefore concerns itself with monetary values rather than with quantities of goods.

The Bureau of Foreign and Domestic Commerce makes for each year, under the direction of Dr. Amos E. Taylor, a careful study of the various foreign transactions of this country. The Bureau prepares annually a statement of this coun-

try's balance of payments, including all the items visible and invisible. The figures are set up in the form of a balance sheet showing the dollar receipts and payments, or the debits and credits. Inasmuch as complete figures for certain types of transactions cannot be accurately determined but necessarily involve estimates, a perfect balance is not to be expected. The Bureau, of course, does not pretend to present a perfect balance, but sets forth the principal items which go to make up the foreign transactions of this country during the year. Furthermore, during a given period a precise balance would not be expected in view of the fact that there is often a lag in the payment of goods over their receipt. On the following page is an abbreviated statement prepared from the Department's balance of payments for 1939 and 1940.

An outstanding fact about the balance of payments for the years shown was the heavy flow of capital into the United States. Much of this was short-term money, or "hot money," as it is sometimes called. This capital inflow was reflected in unprecedented large imports of gold. The heavy influx of capital and of gold continued until about the end of 1940. An earlier inflow of gold had been stimulated by the devaluation of the dollar in January, 1934, whereby the United States paid \$35 an ounce for gold instead of the former \$20.67. Until foreign currencies became adjusted, this higher price attracted gold to the United States where each ounce could be converted into more dollars than formerly. The importation of gold in 1939 and 1940 was due largely to the situation in Europe, which encouraged the flight of capital to the United States where money was regarded as safer.

Expenditures of American travelers abroad reached a peak of over \$800,000,000 in 1929, but declined during the depression. After the outbreak of war they declined very sharply and in 1940 were only \$223,000,000. Immigrant remittances have been declining since 1928 and 1929, partly as a result of restrictions upon new immigration. In 1928 and 1929 approximately \$250,000,000 was sent out each year by immigrants in America. The decline has been particularly marked in remittances to Italy and Greece. Charitable, religious, and scientific contributions have

TABLE IO. BALANCE OF INTERNATIONAL PAYMENTS  
OF THE UNITED STATES  
(In millions of dollars)

Credits or Receipts	1939	1940
Merchandise exports.....	\$3,177	\$4,021
Merchandise export adjustments.....	67	68
Freight and shipping services rendered to foreigners.....	121	186
Expenditures by foreign travelers in United States.....	149	93
Remittances to United States from persons abroad.....	45	35
Interest and dividends received on American capital abroad..	546	525
Government transactions involving receipts.....	44	32
Miscellaneous services rendered to foreigners.....	154	89
Gold exports.....	1	5
Gold earmarked in United States for account of foreign countries (net).....	534	645
Silver exports.....	14	4
Reported foreign long-term capital received (American securities exported).....	3	.....
Foreign short-term banking funds received (excess over funds exported).....	1,159	867
Special transactions of belligerent governments.....	.....	630
Miscellaneous foreign capital received (excess over miscellaneous capital exported).....	69	.....
Paper currency exports (excess over imports).....	117	35
Net residual exports*.....	1,007	1,317
Total Credits.....	<u>\$7,207</u>	<u>\$8,552</u>
Debits or Payments		
Merchandise imports.....	2,318	2,625
Merchandise import adjustments.....	44	44
Freight and shipping services received from foreigners....	249	259
Expenditures by American travelers abroad.....	358	223
Remittances from United States to persons abroad.....	144	118
Charitable, educational, and other contributions from United States to institutions abroad.....	43	54
Interest and dividends paid on foreign capital in United States.	226	195
Government transactions involving payments abroad.....	99	123
Miscellaneous services from foreigners.....	66	63
Gold imports.....	3,575	4,749
Silver imports.....	85	59
Reported American long-term capital exports (foreign securities imported).....	.....	39
Miscellaneous American capital exports (excess over miscellaneous capital imports).....	.....	1
Total Debits.....	<u>\$7,207</u>	<u>\$8,552</u>

\* This residual item consists primarily of unrecorded capital transactions, although it may also include errors and omissions in other transactions.

also shown declines, but in 1940 increased to \$54,000,000. The amounts sent out in 1940 were as follows:

Nonsectarian .....	\$24,200,000
Protestant .....	16,500,000
Jewish .....	10,100,000
Catholic .....	<u>3,000,000</u>
Total .....	\$53,800,000

Interest and dividend receipts by the United States in 1940 amounted to \$525,000,000. Interest and dividend payments by the United States to foreigners amounted to \$195,000,000.

## CHAPTER 8

### PRINCIPLE OF COMPARATIVE ADVANTAGE

**Objectives of International Trade Theory.**—In examining the theoretical aspects of international trade it is well that we have a clear conception of what it is that we are endeavoring to explain, the nature of the problem we are attempting to solve. The task of international trade theory is essentially to explain, first, why trade takes place between countries, that is, why certain goods are imported while others are produced at home. We want to know what determines the articles which enter into international trade and those which are confined to domestic trade. Why does the United States import British cutlery but not British automobiles? Why does the United States export cotton and import raw wool? In other words, why are certain articles objects of international commerce while others are not?

Second, international trade theory endeavors to explain why the terms of trade, or the ratios at which goods exchange, are what they are. Why does a bale of cotton trade for just so much coffee, or so many yards of silk? Why are 10 boxes of Japanese toys the equivalent of 12 American automobile tires or 50 yards of Belgian linen? What determines the total amount of goods and services which a nation must give in exchange for its imports? What determines whether a country gets much or little in exchange for what it exports, and just how much or how little? This is the problem of the terms of trade.

Third, international trade theory seeks to explain the forces which tend to bring equilibrium in a nation's foreign transactions, and in international price and other economic relationships. Economic conditions are constantly changing, so that the terms of trade are never fixed and permanent, but are continually shifting. Similarly, the total volume of trade and the types of commodities traded are undergoing constant change, so



that no nation's trade is ever very long the same. Some commodities become obsolete and new commodities take their places. In spite of all these changes, trade is always tending toward a position of equilibrium and balance, wherein the relationships of the different commodities, of the factors of production, and of the many forces which act and interact upon each other are in a state of equilibrium, and also wherein the total of what is given by a nation equals in value the total of what is received. Equilibrium does not mean a static condition, but that opposing forces are in a state of balance and have attained a stable relationship, until some new force interferes. A position of perfect equilibrium is, of course, never attained, although the exports and imports of a nation (including the invisible items) must ultimately balance. If a condition existed wherein no new disturbances took place, equilibrium in a broad sense would sooner or later become established.

Trade is like the pendulum of a clock which swings back and forth around a point of equilibrium and rest, but which reaches this point only to depart from it. If the pendulum swings far in one direction it must eventually compensate by swinging far in the other direction. Thus over a period of time the total value of what is given by a nation must be equal to that of what is received, assuming there are never bad debts; but for short periods of time, such as a few weeks or months, a balance between exports and imports is not likely to exist. Although instability is a basic characteristic of trade, somehow or other equivalence between exports and imports, that is between the payment and receipt items, eventually obtains. A country's total payments and receipts must eventually balance even though equilibrium is continuously disturbed and in the broad sense is never attained; although never attained forces are continuously working toward it. The surface of the ocean is never calm and perfectly level, although it is continuously tending in this direction, and parts of it may temporarily be at rest.

International trade theory seeks to explain the means by which international economic equilibrium tends to become established. It must explain how the so-called equilibrating forces operate, and how they meet disturbances which tend to interfere

with equilibrium, how trade becomes adjusted to new conditions and to disturbing forces. As economic movements, new inventions, political shifts or other changes take place and necessitate (for a balance) different terms of trade and different economic and financial relationships, what is the procedure by which these new terms and relationships are established? What is the mechanism which tends to bring a balance in the foreign payments and receipts of a nation? The forces and arrangements which tend to bring trade and all international economic dealings to a position of equilibrium, and which cause total export and import values to equal each other over a period of time, are sometimes referred to as the mechanism of international economic adjustment. It is the task of international trade theory to explain the nature of this continuously operating mechanism.

**Countries Differ in Productive Facilities.**—In order to obtain articles by trade, nations must, of course, give something in exchange; consequently they produce more of certain articles than they can themselves consume, and trade the “surplus” with foreigners. A farmer who has good wheat land grows large quantities of wheat and sells the wheat in order to procure clothing and gasoline. This is the same procedure as in foreign trade, wherein nations produce large quantities of goods for which they are specially suited, and exchange them for other goods.

Nations, and also different parts of the same nation, vary greatly in their adaptation for certain types of production. Areas differ especially as follows:

**IN CLIMATIC CONDITIONS.**—Some products require a cold climate while others require a hot one. Rainfall and other climatic conditions vary widely and help to determine what an area produces. This is particularly true with respect to agricultural production, but it also affects various other types of production.

**IN NATURAL RESOURCES.**—Some parts of the world are fortunately endowed with coal and iron while others have petroleum, gold, or copper; others have few minerals but possess especially fertile soils. Such natural resources and physical con-

ditions play an important part in determining the nature of production.

IN THE QUANTITY AND CHARACTER OF THE LABOR SUPPLY.—The amount of labor is a major factor in determining labor costs and thereby the character of articles produced. In the Orient labor is relatively abundant and cheap, while in the United States labor is scarce in comparison to other factors. To be included as a factor in the labor supply is the development of trade unionism and the effects of this upon wage rates; important also are such things as the native abilities of the people, their alertness, aggressiveness, industry, training, and education. In some parts of the world skill in certain occupations is passed on from generation to generation so that the section comes to possess special advantages relative to other sections. Thus, Switzerland makes watches and Norway specializes in fishing.

IN THE EXTENT OF CAPITAL EQUIPMENT.—Modern production requires the use of a great many machines and tools, man-made wealth or capital as it is called. Very little production, even of the most simple nature, takes place today without the use of some tools or equipment. The more extensive and efficient this capital equipment is, the greater is the output for a given amount of effort. Cultivating the soil with a crude plough does not yield the results accompanying the use of tractors and modern farm machinery.

Countries differ greatly in the amount of capital equipment they possess. Advanced nations like the United States and Great Britain have a vast amount of such equipment, while most tropical countries have very little. Unlike climate or resources, the origin of this equipment is not inherent in the physical features of a country but is found in the utilization of a portion of the country's production for the creation of such equipment, rather than its use for immediate consumption. Capital thus represents the accumulated savings of past years. Wealthy nations with a large annual output of commodities find it easier to divert a substantial portion of their productive effort to further production than do poorer nations with relatively small

productive capacity. Some nations with little capital may obtain this by borrowing from other countries.

Regardless of the way in which it came into being, the extent of capital equipment, factories, machines, highways, furnaces, power plants and the like, varies widely from country to country, and is a vital factor in determining the nature and volume of a nation's production.

**IN THE STABILITY AND CHARACTER OF THE GOVERNMENT.**—Some parts of the world, endowed with good resources and productive conditions, are unable to realize their full possibilities of production because of political instability, insecurity, unrest and governmental restrictions. The type of government, laws, social institutions, and economic organization in general vary considerably and have important effects upon a country's production. Governmental instability and inefficiency, and uncertain economic conditions discourage the accumulation of capital and its investment from other countries.

**IN THE PROXIMITY OF AN AREA TO MARKETS.**—In terms of transportation costs, the distance or accessibility to markets influences the character of production. For example, an area may be well suited to the growth of fresh vegetables, but if it is distant from a market for them, such perishable production may not take place. Bulky articles are influenced by nearness to markets more than are articles of high value and small bulk, which can afford to bear high transportation charges. Markets nearby are sometimes closed to certain goods by tariffs and other barriers, so that such markets have little effect. Raw materials or other products unless accessible to markets have little economic significance in international trade.

**Countries Specialize in Production.**—Within a nation production tends to take place in those regions that are best suited for producing the different types of goods. In the United States, for example, iron and steel mills have centered in Pennsylvania and Ohio, chiefly because of proximity to necessary materials and accessibility to markets. Minneapolis is near large wheat and other grain-growing areas and is a logical mill-

ing center. Nevada and Arizona contain valuable mineral deposits and therefore are mining states. The different sections of the United States thus specialize in the production of certain articles. They specialize in the production of those articles for which they are particularly well adapted. As a result, production is more efficient. The reasons why a region is well adapted to a certain industry and concentrates on it, is sometimes obvious and in other cases obscure, but the basic fact of specialization by different sections of a country is clear.

As regions specialize, so countries—which are merely a group of regions or in some cases only a part of a region—specialize in the production of certain articles, in general those articles for which the country is best suited or least unsuited. Economic forces do not observe political boundaries, unless forced to do so by artificial devices, so that production tends to locate throughout the world, at home or abroad, according as conditions are suitable or unsuitable for the particular goods in question.

National and international specialization is merely an extension of the general division of labor, which has been proceeding from early times. An individual does not grow his own food, make his own clothes, and build his own house. Instead he concentrates on one type of work, that type for which he is best suited, and trades the results of his work for the products of other workers. The division of labor among individuals grows into division of labor among regions and among nations. It is geographic or territorial division of labor. The huge industries of the modern world with their complete dependence upon trade represent a high degree of specialization and division of labor. The specialized nature of production throughout the world, and the great advantages accruing therefrom are obvious.

The reasons why certain goods may be produced more advantageously in some sections than in others, why an area is "well adapted" or "best suited" to a certain type of production, are basically because the different factors of production are distributed unevenly throughout the world. As noted above, some sections are endowed with rich resources of one kind, whereas another section is well suited to production of a different sort. A seaport may devote itself to fishing, while an inland town may

be in a rich agricultural area. Labor may be plentiful here, but scarce there as compared to tools, machines, and other items. In some areas good land is abundant but capital equipment scarce, so that the area is better suited to agriculture than to industries requiring factories and a large amount of machines and other capital equipment.

In the production of any article the various factors of production, such as natural resources, capital equipment, and the many other items which contribute to production, must be combined together and they may be combined in various proportions. For example, the production of wheat requires land, workers, and also tools such as ploughs and tractors. Numerous combinations of the amounts of each of these factors used are possible. If workers are scarce and their wages high, but tools plentiful and cheap, each worker is supplied with more equipment (as in the United States) than if a reverse condition prevailed. If workers, however, are abundant and wages low, the proportion in which workers and capital equipment are combined is different; each worker then has fewer tools. This is the condition in the Orient and the Near East as compared to the United States where workers are well equipped.

Because the factors of production exist in relative amounts which vary from one area or country to another, the different countries combine them in different proportions. In a country where labor is relatively plentiful and therefore cheap, but capital is scarce, two units of labor might be combined with one unit of capital, whereas in a country where labor is scarce (and therefore dear in relation to capital), one unit of labor might be combined with two of capital.

Variations between different parts of the world, as to the proportions in which the factors of production exist, cause some areas to be better suited to the production of certain goods than other areas. Some areas have an abundance of cheap land, whereas others have an abundant supply of labor. The conditions which favor certain types of production thus vary greatly from one country to another, and also within a country.

Variations throughout the world in the abundance or scarcity of factors of production, including resources and all the condi-

tions necessary to production, are, it will be noted, basically the reason for the existence of trade. The expression "factors of production" refers not to the narrow classical division of land, labor and capital, but includes all agencies, conditions and facilities which have a part in production. Included are such things as the varying types of resources, buildings, machines, the nature of the government, types of labor, and the other matters discussed above.

Attempts to organize production counter to the dictates of these underlying conditions meet with strong economic resistance. Cotton can be grown advantageously in the southern part of the United States, where climatic conditions are favorable and labor plentiful, while timber is especially abundant in the north and in Canada. An attempt to reverse the output of these sections would in general be rewarded with less cotton and less timber for the same outlay of labor and capital.

**The United States Could, if Necessary, Produce at Home Most Imported Goods.**—The United States is in a position to produce almost any commodity it desired if it were willing to pay the price. If necessary, it would even be possible to grow bananas, coffee, and other tropical products in the northern states of Maine, Minnesota, and Oregon, by providing hot-houses and duplicating climatic conditions of the tropics. The costs, however, would be very high, and only small quantities could be grown. The costs would be much greater than most people would be able or willing to pay, so that the great mass of people would have to go without these articles if importation were cut off. These articles can, of course, be obtained much more cheaply from tropical countries, where conditions and factors necessary for their production exist in favorable proportions; but the United States, nonetheless, could produce them in limited quantities if necessary.

Almost every article that the United States imports could be produced at home, if this were necessary. But in practically every case, the costs would be greater than those for which the articles may ordinarily be obtained from abroad. In some cases the costs would be only slightly higher, while in other cases they

would be prohibitive. The war and resulting production domestically of goods formerly imported have clearly illustrated this. It is true that certain articles, tin and other special metals for example, either exist in small quantities or are lacking almost entirely in this country. Such instances where the article absolutely cannot be produced in the United States in sizable quantities under any conditions, no matter what the cost, are exceedingly rare. The United States with its varied resources is in a specially favored position in this respect. The United States could become self-sufficient and get along without products from abroad with much less difficulty than practically any other nation, but the United States would suffer severely if this were attempted permanently.

The United States produces practically no rubber, tin, silk, coffee, spices, bananas, and pineapples, and produces insufficient amounts for the domestic market of sugar, paper, hides, wool, chemicals, and many other articles. Sugar, for example, is produced within the United States, but in quantities adequate to supply only about one-fourth of this country's requirements. The remainder normally comes principally from Cuba, Hawaii, and the Philippines. Were it not for this outside supply, and were this country required to produce all the sugar it consumes (apart from wartime rationing), the cost of sugar in the United States would be considerably higher, since the domestic production cannot be materially expanded except at greater cost.

The significant fact about all this is that the United States and every other nation could, if they wanted, produce a much greater variety of products than they actually do produce. They could also produce larger quantities of articles the supply of which is now partly imported and partly produced at home. These additional articles and additional supply, however, could not be produced without curtailing production in other lines, that is, without drawing labor and capital from existing activities. If American labor produces automobiles, that same labor cannot produce woollens to obviate the importation of foreign woollens. We cannot have our cake and eat it. This, of course, assumes that the economic machine is functioning smoothly and that the labor supply is reasonably well absorbed. The matter



of the utilization of unemployed labor and idle capital because of maladjustments and other difficulties is a separate question.

**The Principle of Comparative Advantage.**—The articles which a nation produces at home are ordinarily those in the production of which it either has special advantages or in which it has the least disadvantages. Furthermore, goods which it imports from abroad are usually those for the production of which it is not particularly well suited. The coffee, bananas, and other tropical products imported into the United States in large quantities are examples. Such articles can clearly be obtained more cheaply from other countries. Borderline cases, however, exist wherein the differences in advantages are not great. In some cases the advantages of foreign production as compared to domestic production are about on a par. Nevertheless, the principle holds good that the United States—and every other country—tends to produce those things in which it has a relative advantage and to import those articles in which it has a relative disadvantage.

The tendency of countries to concentrate their efforts in the production of articles in which they have special advantages, or in which they have the least disadvantages, is known as the principle of comparative advantage. This merely means that nations tends to produce those things for which they are “best fitted,” and to avoid the production of those things for which they are the “least fitted.” An advantage in a certain article indicates, it will be noted, that the factors necessary to produce that article exist in relative abundance. If an article requires much hand labor, countries with an abundance of cheap labor would probably have an advantage. More will be said below of the meaning of “best fitted,” of what constitutes an advantage, and of the relation of advantages to prices.<sup>1</sup>

In the case of a country that clearly has an advantage in the production of a certain commodity, for example, Brazil in the production of coffee (land suitably situated from the standpoint of climate and other necessary conditions is plentiful), the operation of the principle is simple. But how about the country

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<sup>1</sup> See Chapter 9.

that is fortunate enough to have special advantages in a great many lines, or, at the other extreme, the unfortunate country that has no special advantages in any line? What determines the kind of industries which these countries tend to develop? The answer is that the matter is merely one of each country putting its best foot forward. The fortunate country with many advantages tends to develop only those industries in which its superiority over other countries is the greatest. It does not bother with those industries which other countries can develop, even though these other countries might not be as well adapted to this production as the first country. The problem is one of producing those things wherein a country's labor and capital can be used most effectively or the least ineffectively.

The United States, a country with many natural advantages and an abundant supply of capital equipment, regularly imports certain things it is as well suited to make as foreigners. However, the high productivity of American labor and capital in other fields sets standards of productivity which the less productive fields in the United States are unable to meet. Labor and capital are rewarded best if they are directed toward those industries in which this country is most particularly favored. The most productive fields thus attract the labor and capital.

A country may be favorably situated with reference to a certain article but may not be able to produce its total supply under favorable conditions, and therefore, may import part of it. The law of diminishing returns, or of increasing costs, often prevents the production of adequate quantities of an article, so that the home supply must be supplemented from abroad. The United States thus produces some sugar domestically and also imports sugar. England, though a highly industrialized nation, can nevertheless still grow some wheat to advantage.

The barren country with poor resources and no special advantages endeavors to make the most of what little it has, and, therefore, develops those industries in which its disadvantages are the least. Its efforts may not be very well rewarded, but if such a country is to live and import from abroad, it must produce something for export. If it is to secure from abroad those essential commodities which it lacks, it must offer its own goods

in exchange. Its own production is the greatest and it has more to trade, and therefore to consume, when it concentrates upon articles in which it has the least disadvantages. It, therefore, may cultivate land that perhaps would be standing idle in more wealthy countries, and may trade the products of that land for those of the wealthier country. In the wealthy countries, where labor is relatively scarce, labor can be applied more effectively than by cultivating poorer land, even though such land may be superior to that cultivated abroad. This explains why arable land may lie unused in America whereas in Europe and particularly in the Orient, land inferior to it is cultivated intensively. In foreign countries hillsides are terraced and little land is wasted. In the United States such intensive cultivation would be wasteful and uneconomic due to the existence of more profitable outlets for labor and capital.<sup>2</sup>

**Comparative Advantage Not Absolute Advantage.**—It will be seen that it is *comparative* advantages rather than *absolute* advantages which determine the direction of a country's efforts. Countries in this respect are very much like individuals. An individual, competent in a variety of undertakings, tends to select the occupation in which his ability is the most useful, and where the rewards are the greatest. A person with meager abilities tends to locate in an occupation wherein his deficiencies are the least handicap to him. The occupation may be one requiring only the performing of some simple operation, or perhaps, requiring merely physical labor and almost no mental effort. The rewards are, of course, not very munificent in such cases. The manager of a store or shop may be able to sweep the floors and clean the windows better than the janitor, yet he does not dissipate his energies in this way. His time is better devoted to utilizing his business abilities. A busy executive does not keep his own records or type his own letters, although he may be able to do this better than his clerks. To perform these additional duties would detract from the efficient utilization of

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<sup>2</sup> In the United States, inferior land is sometimes profitably cultivated with modern farm machinery. Such cultivation, however, is extensive rather than intensive.

his supposedly more special abilities, and there would be more lost than gained.

The foreign representative of a large American business was once told by his home office that he should not spend his own time coding and decoding cablegrams, but that this should be done by inexpensive assistants. He had felt that he could save some money but was told that he would do better to be out developing new business, even though he was skillful in coding cablegrams and could probably save some cable expense.

Land that is valuable for growing citrus fruits may also be very desirable wheat land. Yet it is not used for wheat, since it has special advantages for citrus, and citrus land is scarcer and more valuable than wheat land. Labor and materials expended upon it in the cultivation of citrus are much better rewarded in profit to the owner than if they were expended upon this same land in the cultivation of wheat. The citrus fruit produced can be traded (via money) for more wheat than could be grown upon this land with the same effort. Resources thus tend to be utilized for the most profitable purposes, whether the productive advantages that are possessed are absolute or comparative.

### Comparative Advantages and the Standard of Living.—

It follows from the above that countries which are fortunate enough to have a large amount of valuable resources or special advantages, are able to obtain good returns for their efforts expended. They thus tend to have larger production, real incomes and higher standards of living than countries with meager resources and few advantages.

The scarcity or abundance of a country's resources—whether a country is rich or poor—is to be measured in terms of the size of the population. If a country is densely populated its per capita resources may be low; labor then finds life harder than in a country of sparse population where labor needs to cultivate only the best soil and mine the ore nearest the surface. The countries where real incomes are the highest are those of good resources, not too densely populated, peopled by an energetic, capable, and fairly well educated race, well supplied with tools

and governed by a stable and enlightened government. These conditions are conducive to high productivity, and to a high standard of living. Where per capita resources are high—fertile fields, timber, minerals, and the like—labor will find its efforts well rewarded and real wages high. Where that labor is also skillful, energetic, and well supplied with tools and equipment, as in the United States and Canada, its rewards are still greater.

**Benefits of International Trade.**—Many benefits come to a country as a result of its trade with foreign nations. In the first place, international trade makes it possible for people to consume many articles which their country lacks and which they would otherwise have to forego entirely. Thus the United States lacks tin and nickel, while Great Britain lacks petroleum and many other articles. All countries lack certain things, most countries a great many things. Trade furthermore permits countries to consume larger quantities of articles which would be very expensive were it not for foreign supplies. A nation may be able to produce a certain amount of an article, but to produce an adequate supply would mean prohibitive costs.

Trade also increases the total volume of commodities available for consumption, and thereby raises the standard of living. This is because trading permits goods to be produced by the most favorably situated and most efficient producers, who can produce with the same effort larger quantities than could less favorably situated producers. The labor of a country is most effective, and is most bountifully rewarded when it is applied in ways for which the country is best fitted and upon materials with which the country is reasonably well endowed. When energies are utilized in this way the sum total of goods is greater than if the energies were expended in producing articles for which the country was not well suited. As a consequence of trade and competition to sell, the most efficient producers, wherever they may be, are the ones which tend to do the producing. In the competitive struggle they are the ones which usually win out. This tendency is strong even though in a world of numerous regulations and restrictions, large-scale and highly organ-

ized industry, and price and wage rigidities, the most efficient may not always win.

The principle of the survival of the fittest, wherever they may be, is nonetheless continually at work in the production and sale of commodities. The "fittest" may not always conform to our social and ethical ideas, but they are the ones who in general are the most successful in giving the public what it wants, and in giving this most economically and efficiently.

The increase in total production brought about as a result of production by the most efficient and the international trading of the products, is nothing more nor less than one of the benefits which spring from the division of labor. The division of labor, wherein each person or area specializes according to abilities, is not merely a domestic matter but cuts across national boundaries. Production tends to take place in the best location and to be sold in the best market. As a consequence, the volume of production is greater.

The large volume of international trade of modern times represents a very great amount of division of labor, and of individual cooperation in production. The world has traveled a long distance since primitive man gathered his own food, made his own clothes and provided his own shelter. We are far removed from the time when he first began to work with his fellows in the effort to satisfy his wants, later bartering a few simple products with them. Our complicated system of production and exchange, dependent upon a high degree of cooperation, now embraces the entire world. A worker in one country, performing a simple factory operation, may have little conception of his part in the whole. He may be making part of a machine or implement to be used by someone on the opposite side of the globe. That person, in turn, may be helping to produce a raw material which will ultimately, after many others have worked upon it, find its way back to the country of the original worker. This all represents a marvelous amount of coordination in production, uniting the entire world into one economic organization.

The world's productive system operates like a gigantic machine made up of innumerable parts. The machine functions

best when each part does what it is best fitted to do. A screwdriver can be used as a chisel and a chisel as a screwdriver, but the results are not what they are under the reverse process. Attempting to grow wheat on land good only for grazing cattle, or to grow wheat on land especially suited to citrus is not the most efficient use of these agents.

The large amount of international trade, it will be seen, means greater economy in the utilization of the world's resources and man's abilities. It means that the most fertile soils are being utilized, that the most accessible minerals are being mined, and that there is less forcing of square pegs into round holes. Society as a whole has a greater quantity and variety of goods, and the standard of living of all nations is immeasurably higher than if there were no trade between these nations. In any trade the goods or services given are of less importance to the giver than are the goods or services received; otherwise, the traders would have no incentive to trade. This illustrates the beneficial nature of trade to a country. It will be noted that, despite popular notions, a large export trade does not indicate greater prosperity or more desirable conditions than a large import trade. A large and total trade is the thing to be desired.

## CHAPTER 9

### PRICES AND TRADE THEORY IN THE REAL WORLD

**Differences in Price Structures.**—The theories which explain international trade are fundamentally the same as those which explain domestic trade. The reasons that California produces oranges and trades them for Detroit's automobiles or for New England's shoes, are basically the same as those which cause Canada to produce lumber or India jute, and to trade them for English cutlery or Australian wool. As one part of a nation finds that certain goods can be bought more cheaply in other communities, so nations find that certain goods can be purchased more cheaply abroad than at home.

The price of an article is ordinarily the immediate test of whether the article is imported from another nation (or region of the same country), or produced locally. If a foreign good can be bought and laid down at home more cheaply than a similar domestic good, the foreign good will ordinarily be imported. In the modern world, however, with a wide range of regulations and controls, prices by themselves are not the sole test of whether a good is imported or exported. Furthermore, prices are not the result of free and competitively functioning forces. Nevertheless price differences are in general still the basic incentives to trade. The confused mass of regulations on the movement of goods that were piled up largely during the thirties, and the altered economies generally, have not repealed economic laws, nor do they obviate the need for theoretical analysis. The world is still operating on a monetary basis wherein prices play a major rôle. Price analysis is fundamental to an understanding of international economic relations.

Prices of articles, whether at home or abroad, are expressions of their value relationship, so that if a pound of sugar sells for ten cents and a loaf of bread for five cents, this means



that one pound of sugar is the value equivalent of two loaves of bread. If in another country a pound of sugar sells for two francs whereas three loaves of bread also sell for two francs, this means that one pound of sugar is there the value equivalent of three loaves of bread.

If two countries had identical price structures (identical value relationships of goods to each other), there would not be a single article wherein trade would yield a gain to either party. Any article given would be no more valuable in the country to which it was sent than in the country whence it came. The country where one pound of sugar was worth two loaves of bread, could, however, profitably trade sugar for the three loaves of bread which were the equivalent of one pound of sugar in the second country. Or, the second country, where sugar was more valuable in terms of bread (priced at three loaves), might profitably trade two of its loaves of bread for one pound of sugar from the first country. If the price relationship between these two articles were the same in both countries, there would be no basis for trade. Thus it is the difference in price relationships, or the structure of prices, that makes trade possible and provides an incentive to trade. The actual terms of trade—the number of loaves of bread per pound of sugar—is discussed in the next chapter.

The problem of why international trade exists is essentially one of explaining why a certain article has a different value relationship to other articles in some countries than in other countries, that is, why a pound of sugar is the value equivalent in some countries, not of one loaf of bread but of two or perhaps three loaves of bread. We want to know why the prices of certain foreign articles are cheaper than similar domestic articles, allowing for foreign exchange rates, transportation, and other costs. The problem, it will be seen, is not a simple one. Furthermore, influences other than prices enter into the determination of the direction and nature of trade; particularly has this been the case in recent years of increasingly controlled economies.

In the present world, where competition and other economic forces are not free to work themselves out unrestrictedly, much

of our economic theory refers to tendencies which are often held in check or even dammed up completely, by public or private actions. These underlying tendencies, however, cannot be destroyed even though they may, wisely or unwisely, be restrained. To understand the real world it is necessary first to understand these basic forces, regardless of the extent to which they may be controlled by government or seem to be inoperative.

**Price a Result of Equilibrium Adjustment.**—As noted in the previous chapter, nations differ greatly in their adaptations for producing certain goods. In some nations fertile land is plentiful whereas in others such land is relatively scarce but labor is plentiful. A country wherein land is plentiful compared to other factors of production, would probably find that it had an advantage in producing goods such as agricultural products requiring a large amount of land. Such types of goods, which presumably could be produced easily and in abundance, would tend to have a low value in their relationship to other commodities which were more difficult of production.

The value relationship of goods to each other (their relative prices) reflects, among other things, the ease or difficulty with which the different goods can be produced—goods that can be produced easily tending to be plentiful and therefore cheap, and vice versa. The adaptation of a country to a certain type of production—that is, whether a good can be produced easily or not—results largely from the relative abundance or scarcity of the factors and facilities necessary to its production. If a country has extensive forests, for example, lumber can be produced easily and the country is probably well suited to lumbering. The abundance or scarcity of certain factors of production thus helps to determine whether certain goods are abundant or scarce, and therefore cheap or dear. The structure of prices is to a large degree conditioned by the nature and extent of a country's factors of production.

The value relationship of goods to each other, however, is also a reflection of demand for the different articles—whether much or little of an article is wanted and how badly it is wanted. An article, or factor, is abundant or scarce only in relation to

the desires for it. An article may appear to be abundant, yet if the desires for it increase, or if the supply of other articles increases, it becomes relatively scarce even though the absolute amount may not have changed at all. More will be said of this below. To be noted here, however, is the fact that nations or parts of a nation differ in their facilities for producing certain goods, and because of these differences, in one nation certain kinds of goods can be produced easily as compared to other goods, whereas elsewhere these other goods can be produced more easily than the first goods. As a consequence (together with other reasons), the value relationship of goods to each other differs from one country to another.

The comparison, it is to be observed, is not between the ease with which article A, for example, can be produced in one country as compared to the ease of its production in another country, but between the ease of production of article A as compared to article B in the same country, and the situation with reference to the relationship of the same two articles in another country. The ease of production of a certain article is an important consideration in the determination of the size of the supply which is put on the market; and the size of the supply is in turn an important consideration in the price, or in other words, in the value relationship of the article to other articles.

It has sometimes been said that the costs of producing an article determine the price, and that if the costs are high the price is high, whereas if the costs are low the price is low. The costs are determined, it is argued, by the scarcity or abundance of the different factors of production, so that if a certain factor is scarce and dear in price, goods which require it for production have a high cost, and therefore high price. If a certain factor of production, on the other hand, is abundant and cheap, goods which require it have a low cost, and therefore a low price. From this it is reasoned that the costs of production in a country determine what it exports, or to go back further, that it is the scarcity or abundance of factors which determines what it exports. It is said that prices rest upon costs, and that costs are determined by the scarcity or abundance of the factors of production, which determines in the final analysis what is exported.

While the scarcity or abundance of the factors of production has a profound influence upon costs, and costs upon prices, this simple reasoning is incomplete and may be misleading. The sequence of causation does not run from cost to prices, any more than it runs in the opposite direction—from prices back to costs. It may be said that prices determine costs just as much as that costs determine prices.

Prices are the immediate result of the interaction of demand and supply forces, and tend toward that point where these opposing forces are in balance, that is, where demand and supply are equal. If the supply shrinks, due perhaps to a scarcity of some kind, the price tends to rise and thereby shuts off some of the amount demanded, until the two meet. Prices equilibrate demand and supply, and are often even below the costs at which the supply was produced, a condition not uncommon during depression, when demand shrinks. To understand prices it is necessary to understand what determines the size of the supply and also of the demand.

Prices, demand, and supply represent an equilibrium situation wherein all the components are influenced by each other. Costs, in the sense of the difficulties of producing an article (and which are determined in part by the relative abundance of the factors), help to determine the size of the supply. If conditions are such that costs for a particular article are low as compared to costs for other articles, the supply of the article will tend to be larger than if costs were high. If costs decrease as the amount produced increases, the supply will tend to be larger than if a reverse condition prevailed.

The size of the supply is an important factor in determining the selling price, a larger supply tending to bring a lower price, and vice versa. At the same time, selling prices help to determine how high the costs are which can be entailed by producers, and in this manner selling prices influence the size of the supply. A producer must adjust his costs to the prices which prevail in the market, and unless he can produce at costs below the prices necessary to sell the goods he cannot continue to produce. Furthermore, by putting his supply on the market a producer thereby affects the selling prices, an increased supply tending

to reduce the price. The supply and prices are thus closely inter-related and each affects the other. Selling prices influence costs and the supply, just as much as costs and the supply influence selling prices. The size of the supply is essentially a result of how much of the article is desired in the light of the ease or difficulties of producing it, or in other words, its costs.

Demand, based on the desires of the consumers for the article, indicates how much of an article is wanted and at what price or cost. If desires change and more of an article is wanted at the same price, or at a higher price (an increase in demand, i.e., shift of the curve to the right), additional buying takes place and the price may rise. Producers may then be justified in entailing higher costs to meet this demand. Costs thus tend to adjust to demand. The amount that is demanded is influenced by the price, and if a larger supply is not easily forthcoming, and as a consequence the price rises considerably, the amount demanded may shrink. The price thus influences the amount demanded, and the amount demanded, in turn, influences the price. Furthermore, the price of an article is influenced not only by demand for the particular article, but by demand for an almost unlimited list of other goods and services which could be consumed instead. The amount of any particular article demanded thus depends not only upon its own price, but upon the prices of everything else, and in all countries. The price of a particular article, similarly, depends not only upon the amount of it demanded, but upon the amount demanded of everything else, and in all countries.

Since trade is giving something in exchange for something else, the supply of one article is demand for another article, and vice versa. Demand and supply in this sense are identical terms and interchangeable. In a barter economy this is clear. In a monetary economy, however, we ordinarily think of supply as the offering of goods whereas demand is the offering of money, which is a claim on goods. Inasmuch as the two concepts are basically alike, the reasoning that applies to the determination of supply applies also to that of demand. A supply of goods is produced as a means of obtaining, via trade, other goods, and is thus demand for such goods. The introduction of money com-

plicates matters since money may be held more or less indefinitely rather than be spent, and demand may, therefore, be temporarily withdrawn or fluctuate erratically. From this condition, namely the irregularity in the rate of spending of money, together with expansion and contraction in the amount of money, which represent fluctuations in demand, flow many economic complications which cannot be discussed here.

A complete analysis of the pricing process, particularly in the modern world removed as it is from the simple *laissez-faire* economy assumed by earlier economic theory, would take us far afield; but it is to be noted that prices are not determined by any single set of conditions. They are part of a complex situation, and as such are determined by a great many influences which act and react upon each other. A price is the result of the pull of many forces, which tend toward an equilibrium relationship wherein the forces are at the same time cause and also effect.

**Prices and Differences in Factor Equipment.**—The structure of prices, i.e., the value relationship of the different commodities to each other, is not the same in any two countries. This is because of inherent differences in the various countries with respect to climate, resources, machines, labor supply, and such matters (summed up in the phrase factor equipment), as discussed above, which determine the ease or difficulty of producing certain commodities, together with differences in demand, including different habits, customs, needs, institutions, and the many other conditions which go to determine prices. Thus one pound of sugar is worth two loaves of bread here, but three loaves there. It is this difference in price relationship of goods to each other that makes trade profitable.

It has been seen that this difference in price relationship or in price structures is not a simple matter to be explained solely by differences in costs or by differences in factor equipment. It rests upon many differences and a variety of conditions all of which influence each other and which are tied together in a comprehensive general equilibrium. Differences in factor equipment are, however, responsible to an important degree for differences in price structures, and therefore for trade.

The abundance or scarcity of factors must be expressed in terms of value, to have meaning, and in this sense refer to cheapness or dearness. If a factor is abundant it tends to be cheap, so that goods which require a large amount of it for production also tend to be cheap. Cheapness and dearness are relative terms, and a factor is cheap or dear depending upon its relation to other factors. A factor automatically becomes cheaper if other factors become dearer. Cheapness is a matter of proportionality between the factors, and the scarce factor tends to be the dear factor and the abundant factor the cheap factor. The terms cheapness and dearness imply a norm or standard where a factor ceases to be cheap or dear, which norm, of course, does not exist. A factor is cheap or dear only in its relation to other factors in a certain country or region, as compared to its relation to these same factors in other countries or regions.

Comparative advantages and disadvantages rest on the inherent differences in countries, and are measured largely in terms of the relative abundance or scarcity of the factors of production, of the resources and other agencies necessary to the production of an article. While these differences in adaptability to certain types of production are not the sole reason (demand influences must not be omitted), they are, nevertheless, a major reason for differences in the structure of prices.

It was said in the previous chapter that countries tend to export those goods in the production of which they have a special advantage, and now it is said that differences in the structure of prices cause certain goods to be exported. These two statements, it will be noted, come to the same thing. Goods which are low in price are ones in which a country has an advantage. The structure of prices varies from country to country largely because advantages or the facilities for production vary. If a country has an abundant amount of land and therefore an advantage in producing goods requiring a large amount of land, such goods will tend to be cheap. Abundance or scarcity of a factor of production, it will be noted, is one of the more important influences determining relative advantages, and therefore the prices of articles for the production of which this

factor is necessary. Those articles requiring factors which are abundant will consequently tend to be exported,<sup>1</sup> unless some reason prevents.

Factors are themselves articles with prices, and their prices are part of the price structure. An analysis of what determines whether a factor is cheap or dear, therefore, involves the entire pricing process, as discussed above. The price of a factor is like the price of anything else, the result of a general equilibrium adjustment. If we endeavor to explain the price of an article in terms of its factor costs, that is, in terms of the prices of the factors of production which enter into it, we are thus explaining prices in terms of themselves. The summation of factor costs does not provide an adequate explanation of prices.

The cheapness or dearness of the factors, their prices, determines in what proportions they are most economically combined in production. If labor is cheap compared to machines, it is more economical to use more labor and fewer machines in producing a given article than if a reverse condition existed. While the price of a factor helps to determine the proportion in which it is combined with other factors, the proportion, due partly to technological conditions, in turn helps to determine the price. This is because the price of a factor is influenced by demand for it, and the demand reflects the proportion, changes in the proportion ordinarily resulting in changes in demand. The proportion helps to determine the demand and therefore the price, and conversely, the price helps to determine the proportion, an equilibrium relationship.

Technological changes in production may alter the demand for any factor and therefore the price and the most economical proportion in which the factors are combined. Technological changes, by altering factor relationships and the most economical proportion, may favor one country over another and alter a country's comparative advantages, depending upon which factors a country has in abundance. If factor relationships were

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<sup>1</sup> Not all articles produced by an abundant factor are always relatively cheap. The cheapness of a factor may permit its use for articles ordinarily produced by other factors, so that the articles may not necessarily be cheap enough to export. In parts of Central America, for example, mahogany is so cheap that it has been used for railway ties, yet mahogany railway ties were not exported.



the same in two countries, the technological processes would tend to be the same; to be exactly the same, however, it would be necessary to assume perfect competition, identical demands, and other unreal conditions.

The cheapness or dearness of the factors of production (based largely on their scarcity or abundance) plays an important part, it will be seen, in the determination of the structure of commodity prices, although, as discussed in the previous section, this is only part of an equilibrium condition and cannot be considered separately. To the extent that factor cheapness or dearness helps to determine which prices are high and which are low (and it is a large extent), it helps to determine whether or not a country has an advantage with respect to a particular commodity, an advantage ordinarily existing when a commodity can be produced and offered at a low price.

The value relationship of the factors, their cheapness or dearness, is therefore a major influence in the determination of the types of articles which can be produced cheaply, and in the production of which a nation has an advantage. Articles requiring a large proportion of factors which are abundant and cheap, are ordinarily ones which a country exports, whereas articles requiring a large proportion of factors which are scarce and dear, are ordinarily the ones which a country imports. To consider factor cheapness and dearness as a complete explanation of what a country exports would, however, be to slip into the fallacy of regarding costs as a complete explanation of prices.

The immediate consideration as to whether an article is imported or exported is ordinarily its price, regardless of factor costs. While differences in the structure of prices from country to country indicate what is exported and what is imported, this is not a real explanation, since we must know why these price differences exist. The reasons why prices vary from country to country and why an article may be cheap here or dear there, involve a host of forces, the entire pricing process. Factor equipment in the sense of the cheapness or dearness of the factors of production, is one of the major price determining forces, but only one and cannot be determined independently of demand and all the other forces.

It is sometimes said that if the factors of production existed in two countries in identical ratios (from the standpoint of value), neither country would have any advantage over the other, even though one country was rich and well endowed with productive facilities, while the other was poor. No trade, it is said, would then be profitable. While such conditions would tend strongly to make trade unprofitable, the reasoning puts the emphasis on cost differences rather than on price differences. It neglects demand and involves the same fallacies noted above. To the extent that price differences between countries rest upon differences in factor equipment, this approach to the problem is not without some basis. It is true that the difference between the price of an article in one country and its price in another country is determined to a very large extent by differences in factor equipment. While there is thus some ground for saying that trade takes place because of differences in the relative supply of the factors of production, this explanation is incomplete. Refined and meticulous analysis often removes a problem a considerable distance from real life, and from the practical standpoint it may be convenient, and is also correct, to say that the principal cause of trade is found in the varying manner in which the factors of production are distributed throughout the world.

**Prices and Exchange Rate Equilibrium.**—Whether the price of an article (or the price of a factor of production) is dear or cheap in comparison to the price of a similar article abroad, can be determined only after the establishment of a rate of exchange. The cost to us of any foreign article varies with the rate of exchange. Yet the rate of exchange itself depends upon how much of the foreign good is being bought, since demand for the article, and therefore for foreign currency with which to pay for it, affects the exchange rate. The rate of exchange is thus itself partly determined by the cheapness or dearness of the article abroad, cheapness or dearness determining whether the article is imported or exported and the extent. At the same time, the cheapness or dearness abroad is determined in part by the rate of exchange. Importation of the article creates a de-

mand for bills on the country whence it came, and thus influences the rate of exchange on that country. If the good is imported, the rate of exchange tends to become higher because of this fact, and the price of the foreign good, therefore, dearer in comparison to that of the domestic good. Conversely, if the good is exported it creates a supply of foreign bills and thus affects exchange rates. Movements in the rate affect the cheapness or dearth of the good abroad.

Goods exported and imported (including invisible items) must balance in value. The demand and supply of foreign bills, a result of exports, imports, and other foreign transactions, bring about a rate of exchange which equilibrates these two forces, and thereby helps to bring a balance between the value of goods exported and goods imported, or to be precise, between a country's total foreign payments and receipts. For example, if a country's total import items are large in relation to its export items, the demand for foreign currency with which to pay for the imports is strong, and the rate of exchange on foreign countries tends to rise. This makes foreign goods more expensive and tends to reduce their importation, thereby promoting a balance between exports and imports. A higher rate also tends to encourage exports since exporters receive more local money for their foreign bills. The expansion of exports also helps to bring about a balance between imports and exports.

If the gold standard prevails so that the gold flows out of the country which is importing heavily and which therefore needs a large supply of foreign money, the contraction in currency and the resulting decline in prices and output tends to reduce monetary incomes. At the same time, the country which is exporting heavily and which receives gold tends to have higher prices, output, and monetary incomes. This shift in incomes, it will be observed, tends to discourage purchases abroad by the country with heavy imports, gold exports, and reduced incomes, and to encourage purchases by the country with heavy exports, gold imports, and larger incomes. These movements tend to promote a balance between exports and imports, and at the same time to alter the nature of the trade.

If the gold standard does not exist, movements in exchange rates may be quite wide. Such movements often take place promptly in response to changes in the demand and supply of bills and in so doing bring a balance between a country's foreign payments and receipts. This adjustment in exchange rates, however, may alter materially reciprocal demand, and by making some goods cheap and others dear cause changes in the nature and extent of trade.

Movements in exchange rates, constantly taking place as a result of shifts in exports, imports, and other items, thus may alter the entire situation with reference to the cheapness or dearth of foreign goods. They may alter the comparative advantages or disadvantages of nations. If exchange rates rise, a foreign article may become more expensive and cease to be imported, and vice versa. Exchange movements may stimulate or discourage certain trade, but as this trade as a consequence expands or contracts it in turn alters exchange rates. We are confronted with a broad equilibrium situation involving many forces, all the components of the pricing process and in all countries. An explanation of differences in price structures, it will be seen, cannot be confined to a simple analysis of conditions in one country, nor can it assume a given and predetermined rate of exchange. The entire world and innumerable influences are involved in the equilibrating process.

**Prices and Comparative Advantage.**—Whether a nation can produce and sell a particular article abroad, that is, whether it has a comparative advantage with respect to the article, depends upon its ability to lay down the article abroad at a lower price than that of competing foreign goods. To a foreign buyer deciding between competing similar goods the principal considerations are: (1) the prices of the goods as quoted by the producer or seller, (2) the rate of exchange on the seller's country, which expresses the cost to the buyer in his own currency, (3) transportation charges including insurance and related items, and (4) customs duties. It is in terms of prices that comparative advantage is registered, and if a nation can continuously offer an article abroad at a price to the buyer in his own money which

is cheaper than that of similar goods, foreign or domestic, this is almost conclusive proof that the exporting nation has a comparative advantage with respect to the article, on the basis of prevailing demand and other conditions.

In order to compare prices of goods from various countries the prices must be stated in terms of a common denominator, that is, the foreign price must be multiplied by the rate of exchange on that country. For example, if one American dollar will buy about 30 francs, goods costing 30 francs in France would be equal in price to goods in America costing one dollar, apart from transportation, tariffs, and such matters. If similar French goods could be bought for only 20 francs, America would probably find that they could be imported from France more cheaply than made at home. The fact that exchange rates may be fluctuating does not alter the procedure materially, although it may alter the cost to the importer of foreign goods, and make his trade more uncertain and difficult.

When trade is taking place and exchange rates are reasonably stable an importer can quickly compare the cost to him of competing foreign goods by converting the foreign selling prices into his own currency and by making allowances for transportation and other costs. In this calculation, the prices and exchange rates are ordinarily the most important considerations, apart from governmental restrictions. The competitive position of a nation with respect to the export of a particular commodity therefore is indicated largely by these two items: namely, the internal price and the rate of exchange. If a certain nation's commodity is cheaper to foreigners than that of some other nation it is probably because either exchange rates on that nation are low, or the price of the article in the country of origin is low; that is, low relative to the prices of other articles in the same country, as compared to its position in the price structure in other countries.

If exchange rates on a country become depreciated and because of this certain of its goods become salable abroad, this means that a large supply of such a country's currency is being offered on the world market, or that less of it is wanted at the former price, a large supply relative to the demand. The coun-

try may be importing heavily so that exporters to it have generous amounts of its currency for sale; it may be seeking to send its capital abroad and offering increased amounts of its currency in exchange for foreign money; it may be experiencing a price inflation so that foreign buyers of its goods reduce their purchases because of the high prices, until a fall in exchange rates offsets the rise of prices; or it may be confronted with political uncertainties or other conditions which alter the demand and supply relationship of bills. Whatever the reason, if the fall in exchange rates is not accompanied by a compensating rise of internal prices, the goods of such a country become cheaper to foreigners. Wherever the exchange rate settles, this rate is an important consideration in determining the costs to foreigners of an exporting country's goods. Exchange rates, in turn, it is to be remembered, are influenced by the extent to which foreigners buy or do not buy.

Under a condition of relatively stable exchange rates and free economies, price structures largely indicate what is exported, and also what is imported. Possible foreign buyers can easily determine which of a country's goods can profitably be bought by examining the prices. The goods which are low in price compared to foreign goods, after conversion into foreign currency through exchange rates, are those in which a country has a comparative advantage, and are the goods which ordinarily are exported.

In any country, as noted above, it is the goods which are particularly low in price there in terms of other goods, as compared to the ratio which these same goods hold to other goods elsewhere, which are exported and in which a country has a comparative advantage. If a country is going to export anything it exports those goods which are low in price there as gauged by the price structures of other countries. Such goods are the ones in which its advantage is the greatest or its disadvantage the least. Since every country must export something if it is to buy any foreign goods, it exports those goods in which its comparative advantage is the greatest, which means those goods which have the relatively lowest prices at home. The amount of such goods exported is determined essentially by how badly it

wants foreign goods, and also how badly foreigners want its goods.

As discussed in the previous chapter, nations differ in their adaptation for the production of different goods, and in some countries certain factors of production are plentiful while in other countries they are scarce. These differences in countries determine the relative ease or difficulty with which an article can be produced, and are reflected in the price of the article. If the factors necessary to produce the article are scarce, it is produced in relatively small quantities, if produced at all, and its price is high. No comparative advantage then exists with respect to it and the article would not be exported, unless the country were extremely hard pressed for foreign goods and were compelled to expand its exports so as to obtain foreign currency with which to buy such goods.

Comparative advantage, it will be noted, finds expression in monetary prices and exists with respect to those commodities which are specially low in price at home, and which can be offered at low prices abroad after the prices are converted into foreign money. Comparative advantage is thus not measured in terms of hours of labor, sacrifice, or effort expended. A nation may be poor with meager resources and inferior equipment so that a certain good is produced with considerable effort, yet if labor is very plentiful and wages sufficiently low the good may be produced and offered abroad at low prices. China, for example, where labor is abundant and cheap, has an advantage in the production of things requiring much hand labor, such as laces and carved wood. Measured in terms of social costs and effort expended, the cost of hand lace is high, but in terms of prices abroad the lace is cheap. The test, therefore, of whether a nation has an advantage with respect to a particular article is not the number of days of labor involved, but rather whether the nation can offer the article abroad at a price, including exchange and all other items, which is low enough to compete with the prices of similar goods from other nations.

In both international trade and domestic trade, goods tend to be produced in the cheapest market and sold in the dearest market, cheapest and dearest after allowing for exchange con-

version, costs of transportation, and the like. It is to be remembered that exchange rates are themselves determined, in part, by the trade which they in turn help to make profitable or unprofitable, and that we are dealing with variables which are interdependent. When a domestic producer throws his supply on the market, he thereby affects the price; when he exports his goods, he also affects the exchange rate and through this the price in the market in which he sells. Whenever the price or the exchange rate moves, a country's comparative advantage position may be altered; in fact, all or any number of countries may be affected.

Goods which can be produced at low costs and offered at low prices, all things considered, tend to undersell and drive out high-cost goods of equal quality. Under capitalistic economies, even in restricted form, competition for markets is continuous and relentless, and it is the producers who can consistently offer their goods at the lowest prices who tend to survive.

It has been pointed out that costs of production do not by themselves determine selling prices. Whether a nation can produce and sell a certain article depends upon its ability to lay down the article abroad cheaper, everything considered, than a competing nation. While in the determination of this price many forces enter, from the standpoint of a particular producer it is his costs that appear to control. To him the rate of exchange and prevailing market prices are given and are determined apart from his own actions. His choice under prevailing conditions is to sell or not to sell, and his costs are the principal deciding factor. In this sense it is the low-cost producer who manages to get the business. The low-cost producer is the one who has the greatest comparative advantage. His advantage as compared to his foreign competitors may not be an absolute one, but from the standpoint of his own country or region his advantage in selling his goods elsewhere is greater than that of other home producers (not necessarily producing the same article) who are unable to sell abroad.

The ever-vigilant competition of low-priced goods with high-priced goods, and the tendency of low-cost producers to gain the upper hand, is the force through which a certain industry is led



to expand while another must contract, according as the competition is successful or unsuccessful in satisfying the buying public's demands most economically. It is a main force through which production becomes organized along international lines. It decrees that this country produce wheat, that country steel, and a third country textiles. It also has an equalizing effect upon selling prices so that the prices of a commodity in two markets tend to differ by an amount not much greater than the costs of transportation between the markets. Because of competition to sell, no goods are likely to remain materially higher in one market than in another, apart from transportation, tariff differentials, and artificial restrictions.<sup>2</sup> These underlying tendencies continue strong.

The superior competitive power of goods which can be offered at low prices in the relentless battle for markets, carried on all over the world, is the means through which the principle of comparative advantage operates. It directs industries to certain areas causing factories to spring up here rather than there. It causes cotton to be grown in Texas rather than in Canada, and iron and steel to be produced in England rather than in Peru.

**Theory and the Real World.**—When we come to apply the theoretical reasoning of international trade to the real world in which we find ourselves, a crazy irrational world, we discover practical conditions which seem out of harmony with theory. The economic system is in many ways far removed from that which theory oftentimes assumes. Artificial restraints on trade

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<sup>2</sup> The practice known as dumping—selling goods abroad cheaper than at home—is ordinarily an attempt to adapt the price to different buyers, although it may be an attempt to obtain a foothold in a market. This procedure is similar to the policy of a monopolist in charging different prices to different consumers when it is difficult for them to resell the products to each other. Electric power is often sold at different rates for different types of consumers; railways commonly have different rates for different commodities even though the cost of the service may be identical.

Where dumping is carried on under a free economy and at a profit to the producer, cost calculations for that portion of the goods dumped may omit overhead and other fixed charges which must be borne by the producer. The portion of goods sold at home is thus made to bear this burden of overhead. The only costs charged against the goods dumped may be marginal or prime costs—the costs of producing the extra units—as against the average of total costs charged against the goods sold at home.

are the rule and interfere with the free flow of goods to markets. Competition is far from perfect, and production and trading are to a large extent monopolistic or semi-monopolistic. Transportation facilities and costs are influenced by subsidies and a variety of conditions. Exchange rates are pegged or controlled by numerous devices. Internal regulations, price and wage rigidities, and a wide range of governmental and private activities both nationally and internationally alter the situation radically.

Much theory is built upon the assumption of a free economy, and if not *laissez-faire* then an approximation to it; yet the modern world has moved a considerable distance from these conditions. The nineteenth century system, based on free enterprise wherein capital was relatively unfettered in its search for profits, is gone. In all countries, trade and industry—in fact, most economic activities—are largely conditioned by governmental policy and procedure. Governments have definitely accepted the objective of social welfare, and are directing actions to this end.

Only a simple survey of the world is needed to reveal that production and trade are not organized according to natural or comparative advantages. In addition to monopolistic and governmental influences trade is influenced by nationalistic and emotional forces, as illustrated by the ties of Latin America to Spain and of colonies to the mother country. Most nations are more interested in maintaining their "way of life" than in extending trade. International trade is commonly sacrificed to national ends. Trade tends to follow accustomed channels, is frequently inefficient and subject to mere inertia. Imperfect knowledge on the part of producers regarding markets and the selling prices which prevail there sometimes holds trade to familiar routes, as do risks of new ventures, perhaps due to political uncertainties. No simple formula will describe the international productive organization.

Social, political, institutional, historical, artificial, and even accidental factors have often led to the development of industries in one place rather than in another, and to the flow of trade this way rather than that way. They have led to the migration of peoples and skill from one country to another country,

to the promotion of education and invention, or to the lack of these, and to the settling of some parts of the world in preference to others. The economic organization of the world is not to be explained solely by the principle of comparative advantage, although it is a strong tendency. Political expediency, and the seeking of special objectives, public or private, and innumerable other influences have all played a part. The principle of comparative advantage is to be understood as a tendency, and a strong tendency, rather than as a complete and final explanation of why the various industries are distributed throughout the world as they are, and why trade is precisely what it is.

While much of the world's trade and the distribution of industries seems to be patterned on no rational basis that can be explained by economic theory, the case for theoretical reasoning is not easily dismissed. Economic forces, the subject matter of theoretical reasoning, underlie the entire complicated and confused system, and represent powerful tendencies pulling this way or that. They are not nullified by special circumstances any more than the airplane refutes the law of gravitation. If the theory of international trade is attempting to explain a system which does not exist, or exists in a limited sense, this does not mean that the theory is invalid; it should, however, be adapted to a changing world. Institutional changes do not invalidate theory, but may compel further and new analysis, especially from the standpoint of regulatory techniques. This is particularly the case today, and in this analysis theoretical tools must be well supported by consideration of the world as it is. For this reason attention is given in subsequent chapters to procedure, current developments, and trends.

## CHAPTER 10

### TERMS OF TRADE

**Quantities and Values of Goods Traded.**—We have seen how international trade promotes specialization and efficiency in production, and brings a better utilization of resources and a greater volume of production. We have also considered why a nation exports certain articles and imports certain other articles. The present chapter deals with the terms of trade and how they are arrived at; that is, the forces which determine how much a nation must export in exchange for what it imports. We want to know what determines the amount of a nation's goods and services which must be given in order to pay for the goods and services which it receives from abroad. This is the second objective of international trade theory mentioned at the beginning of Chapter 8.

It is, of course, true that the exports of a nation must be equivalent in value to its imports, since one pays for the other—in any trade that which is given automatically equals that which is received; but why do exactly so many bushels of wheat, yards of cloth, and tins of food exported together equal in value so many tons of steel, automobiles, and gallons of oil imported? Why no more or no less? The problem is somewhat the same as determining, when individuals trade goods, why each is able to obtain just so much and no more.

The value of a country's exports, or imports, may move very differently from the physical quantities of the goods involved. Imports, or exports, according to value figures, may be increasing, yet the physical quantities of the goods may not be increasing, or if increasing then not at the same rate as the values. For example, exports from the United States increased from \$7,920,000,000 in 1919 to \$8,230,000,000 in 1920; yet the quantities actually declined. The price level was rising

rapidly during these years, and the quantity of goods exported in 1920 was actually less than in 1919 even though the value of exports rose. The value of imports increased sharply in 1920, but the quantity figures increased only slightly. The value of imports and exports is thus one thing, whereas the physical quantity of goods which constitutes them is something else. Balance of payment studies deal with values, but from the standpoint of real income and benefit derived from production and trade, we are concerned with physical quantities as well as with monetary values.

In some nations goods which are exported are produced easily and with little effort. Yet these goods are often traded abroad for goods which require much more effort to produce. For example, the United States exports wheat to China and receives in return silk and tea. The wheat represents much less labor to the United States than does the same value in silk and tea to China. Again, India imports manufactured articles from England and sends in return jute and tea. The manufactured articles represent much less effort on the part of England than does the counter-value in jute and tea on the part of India. Hand-made laces and embroideries coming into America from the Philippine Islands do not buy for the Philippines enough American food products and machinery to represent an equivalent amount of toil on the part of Americans. If the rates at which the above goods exchange were altered so that China could get more wheat for her tea, India more manufactured articles for her jute, and the Philippine Islands more food products for the laces and embroideries, the trade would be more nearly equal in terms of effort. There is, of course, no accurate way of measuring and comparing effort or sacrifice. It is clear, however, that the quantities of goods traded are at present equal only in terms of value, that is, in monetary value as expressed through prices and exchange rates. They cannot be said to be equal in terms of labor or sacrifice, nor in a physical sense because bushels and pounds and yards do not mix and cannot be compared.

The quantities of goods and services given by a nation in exchange for the sum total of goods and services received from

abroad reflect how the gains which trade gives are shared by the trading nations. The more a nation receives for the same goods, the greater the gain. Such gains, however, cannot be measured precisely. In any trade, both parties presumably gain, or expect to gain, else the trade would not take place. To determine accurately which gains the more and how much more is impossible since we are dealing with incommensurable and non-comparable data. For example, if an orange is traded for an apple we cannot say that one party benefited twice or three times as much as the other. Presumably they both benefited, probably unequally, but we have no standard of comparison. Similarly, in international trade we have no way of measuring the relative gains. Trade, however, is frequently of greater importance to one nation than to the other. Furthermore, any shift in the terms of trade may favor one nation or the other.

To speak of terms of trade as favoring one country or another is somewhat misleading, since it is impossible to measure precisely the respective gains. Favorable or unfavorable terms have more meaning with reference to changes in the terms of trade, or with reference to what the costs to a country would be if it had to produce at home the goods imported. If a country gets more imports in exchange for a given volume of exports than it had formerly received, we can say that, other things being equal, the terms of trade have become more favorable to it. Or, if a country obtains goods very difficult for it to produce and gives in exchange goods very easy for it to produce so that it has a large gain, whereas the foreign countries with which it trades receive goods which they could produce at home with only slightly more effort and therefore have small net gains, the terms are clearly favorable to the first country.<sup>1</sup>

Trade is not between only two nations, but between many, and is part of a general equilibrium so that a shift in the terms of trade anywhere may affect several or all nations. As noted above, Brazil may sell coffee to the United States but prefer to buy British goods or those of other countries. If Brazil gets less for her coffee, trade between other nations is thereby affected.

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<sup>1</sup> For a further discussion of the terms of trade see Chapter 15, Contemporary Theory.

If Brazil has fewer American dollars because of a fall in the price of coffee, she tends to buy less from Great Britain. Britain may then move into other markets, and come into more direct competition with American exporters, with a consequent lowering of the prices of American exports. America, however, would probably continue to get its coffee cheaper, in terms of its exports, than it had originally. The ramifications may be extensive. The terms of trade are always changing, and in so doing favor one nation or another. While it is impossible to measure the distribution of the gains, the terms of trade are of obvious importance to the trading nations and reflect the benefits derived. National policies such as those which have to do with currency, prices, exchange rates, or the free flow of commodities alter the terms of trade, at least temporarily, and may have extensive consequences.

**Reciprocal Demand.**—The terms of trade are the result of a multitude of forces which are sometimes summed up in the expression reciprocal demand. This refers to the demand of one country for the goods and services of all other countries, and to the demand of all other countries for the goods and services of the first country. Some countries are vitally dependent upon foreign sources for certain articles. Other countries are reasonably self-sufficient as regards most essential goods. If a country produces only such goods as are hard for other countries to produce and are strongly desired in large amounts by other countries, it can probably obtain goods in exchange for them upon a favorable basis of trade. If, however, a country produces many goods which can be readily produced abroad and for which other countries do not have a large and insistent demand, while it wants their goods urgently, it may have to offer generous amounts of its own goods in trade. This relative pull of the demands of countries for the goods and services of each other, that is, relative volumes demanded, is what is known as reciprocal demand, and is the underlying force which determines the ratios at which countries exchange goods with each other.

It will be observed that reciprocal demand is merely another way of referring to the general principle of supply and demand

and the theory of value and price, applying the principle to nations in their trade dealings with each other. As previously noted, the concept demand is similar to that of supply. In trade, goods offered are commonly considered supply, but they also constitute demand for other goods. The supply or offering of a commodity is at the same time demand for some other commodity, that which is received. Demand and supply are thus similar concepts viewed from different positions. An equation means equality of the two sides, so that in the demand and supply equation either side may be substituted for the other. Viewed in this manner, the concept of reciprocal demand, it will be noticed, includes the supply factor and one might as readily speak of reciprocal supply as reciprocal demand; the two expressions are synonymous.

The matter of elasticity and inelasticity is also applicable to international demand and supply. The nation with an insistent or inelastic demand for goods of other nations may be required to pay a high price for them in terms of goods given in exchange. This, however, is not necessarily the case, since foreign countries may desire large quantities of its goods and in buying them supply it with a generous amount of foreign currency with which to buy the goods it urgently requires. The rate of interchange of products may thus be favorable to it in view of the large amount of foreign currency which it receives. Insistency and elasticity of demand are, in general, important only in the short run, making for fluctuations in the terms of trade rather than being of great influence in long-run relationships.

When we speak in general terms of the strength of a nation's demand for foreign goods, we are speaking not with reference to demand for any particular commodity, but with reference to a composite of demands for all commodities imported. In the case of the United States, for example, it is a question of how urgently its citizens want foreign rubber, coffee, tin, wool, etc., and how large quantities are wanted; also what the United States has to offer in exchange and how urgently foreigners want what it has and in how large quantities. The urgency of the demand of any country for foreign goods in general may, however, always be reduced by the production, at home, of



those commodities in which it is currently in the least unfavorable position.

Reciprocal demand thus refers not merely to the demand of one country for particular goods of a certain other country, but to the demand of a country for all foreign goods and services, as well as to the demand of the entire world for its goods and services, and is subject to constant shifts as a nation alters its pattern of production.

The demand of a country is to be measured in terms of what it has to offer, since demand is not effective unless backed by an offer of something in exchange. What a country can offer and sell abroad is thus the basis of its purchasing power for foreign goods. The more strongly a country's goods are desired abroad, and the larger the amounts, the greater is its purchasing power over foreign goods. If it sells large quantities of its goods abroad, it receives large quantities of foreign currency, which may then be used in purchasing foreign goods. At the same time, the more it offers abroad, other things being equal, the lower the price, in terms of imports, at which it must sell.

If foreign goods are not especially desired by it the foreign currency may sell at a low rate of exchange, relative to its internal purchasing power, in which case the country in question can obtain larger quantities of foreign goods; the terms of trade are then more favorable to it. Relatively low exchange rates, however, reduce the buying power of the other country, since in such country the currency of the first country is more expensive. This makes the terms of trade more unfavorable to the second country. Movements of exchange rates relative to comparative domestic purchasing powers of the currencies concerned thus tend to alter a country's buying power abroad and also the amount of foreign goods demanded by it. They affect the terms of trade and also are affected by the terms of trade. Nations are tied together in a comprehensive demand and supply relationship wherein the movement of exchange rates or of any factor tends to affect all the others.

We are assuming a condition of relatively free exchange rates rather than fixed rates as under the gold standard. Under the historic gold standard, wherein gold flowed freely and

affected price levels, the price movements altered the terms of trade in response to changes in reciprocal demand. An increase in the amount demanded by a certain country tended to raise its exchange rates on foreign countries; and under the gold standard, if the rise in rates caused gold to be exported, to lower prices and incomes at home and raise them abroad. This condition of altered prices and incomes changed the terms of trade unfavorably for the country having the increased demand. A reduction in the amount demanded and a resulting import of gold and higher prices tended to have a reverse effect, and to react favorably on the terms of trade of such country.

The imposition of a tariff may alter the terms of trade, temporarily at least, in favor of the country imposing the tariff.<sup>2</sup> If the gold standard prevails, a tariff on imports tends to bring gold into the country to help pay for goods exported, since imports are discouraged by the tariff. The influx of gold tends to raise prices and incomes in the country receiving gold and to lower them in countries losing gold. Higher prices and incomes may give an advantage in trade with other countries. If the gold standard does not exist, a tariff which discourages imports tends to raise the exchange value of the currency of such country with the tariff, because of a relatively reduced supply of its currency abroad. This means that currencies of other countries become cheaper in the country with the tariff since exports go out uninterruptedly—unless affected by some other situation. This shift in exchange rates, if unaccompanied by any, or at least a proportional change in relative national price levels, makes foreign goods cheaper, while the goods of the country with the tariff become more expensive abroad. The alteration in the terms of trade helps to offset, but usually only in a very small degree, the evils of a tariff, as discussed in Chapter 25. The problem of fixed rates is discussed elsewhere.

The question of international demand, and how the benefits of trade are shared, was discussed about 100 years ago by John Stuart Mill. Mill wrote as follows:<sup>3</sup>

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<sup>2</sup> Professor Frank Graham doubts whether it is possible to alter the long-run terms of trade by manipulations of this nature.

<sup>3</sup> John Stuart Mill, *Principles of Political Economy*, Vol. II, Ch. XVIII.

If, therefore, it be asked what country draws to itself the greatest share of the advantage of any trade it carries on, the answer is, the country for whose productions there is in other countries the greatest demand, and a demand the most susceptible of increase from additional cheapness. In so far as the productions of any country possess this property, the country obtains all foreign commodities at less cost. It gets its imports cheaper, the less the extent and intensity of its own demand for them. The market is cheapest to those whose demand is small. A country which desires few foreign productions and only a limited quantity of them, while its own commodities are in great request in foreign countries, will obtain its limited imports at extremely small cost, that is, in exchange for the produce of a very small quantity of its labour and capital.

. . . an increase of demand for a country's exports in any foreign country, enables her to obtain more cheaply even those imports which she procures from other quarters. And conversely, an increase of her own demand for any foreign commodity compels her, *cæteris paribus*, to pay dearer for all foreign commodities.

The law which we have now illustrated, may be appropriately named, the Equation of International Demand. It may be concisely stated as follows: The produce of a country exchanges for the produce of other countries, at such values as are required in order that the whole of her exports may exactly pay for the whole of her imports. This law of International Values is but an extension of the more general law of Value, which we called the Equation of Supply and Demand. We have seen that the value of a commodity always so adjusts itself as to bring the demand to the exact level of the supply. But all trade, either between nations or individuals, is an interchange of commodities, in which the things that they respectively have to sell constitute also their means of purchase: the supply brought by the one constitutes his demand for what is brought by the other. So that supply and demand are but another expression for reciprocal demand: and to say that value will adjust itself so as to equalize demand with supply, is in fact to say that it will adjust itself so as to equalize the demand on one side with the demand on the other.

Mill's Equation of International Demand is merely a statement that what is given equals in value what is received, which, of course, must always be the case in any trade since each article pays for the other. While it is tautological, it is, nevertheless, a

statement which is often overlooked in the formulation of governmental policies.

The forces summed up in the expression reciprocal demand, rather than reciprocal demand itself, determine the terms of trade, that is, the quantities given in comparison to those received. Demand for an article is meaningless unless related to a price. Since the amounts demanded vary with the price, demand thus refers to the amounts demanded at a series of prices, the prices being the amounts which must be offered in exchange for the goods demanded. Similarly, a nation's demand for foreign goods and services would be a hypothetical schedule of the amounts of all foreign goods and services desired by it and from all countries, at various prices—that is, at various amounts of its own goods and services which must be offered to buy them. In view of the great variety of goods and services available for trade on both sides, the possible combinations which make up both demands are infinite in number. Nevertheless, we may conceive of a nation as having a (changing) demand schedule for foreign goods and services (according to the terms of trade actually established), consisting of composite amounts of foreign goods and services desired (at the prices implicit in the current terms of trade) from all countries (with infinite variations), and corresponding amounts of its own goods and services (also with infinite variations) which it is willing to offer to obtain them.

A wide range exists in the size of countries and in the volume of their demands. The absolute volume of a country's demand for foreign goods and services is not the important consideration, but rather the relation between the volume which it demands from abroad, and the volume which foreign nations demand of it. If it has a large demand and if foreigners want little from it, the terms would tend to be less favorable to it than if the reverse situation prevailed. Since the volume of demand refers to what it offers, and since what it offers is what foreigners take and therefore demand, the volume of demand can be measured only in terms of the ratio of goods traded (price), which is the question to be explained. Although the demand on one side necessarily equals the demand on the other

side as a result of equilibration through price, during the equilibrating process a strong demand can pull the ratio in an unfavorable direction for the nation with the strong demand, and vice versa. Similarly, a shift in demand on one side may require new terms of trade for equivalence. With even a slight change in the terms of trade, however, the reciprocal demand (supply) schedules will shift in such a way as to reduce the relatively strong, and increase the relatively weak demand, and thus prevent any further movement in the terms.

## CHAPTER 11

### TERMS OF TRADE (CONTINUED)

**Efficient versus Inefficient Countries.**—We have already noted that nations differ in their facilities for producing certain goods, some nations being well adapted to certain types of production, whereas others are ill adapted for such production. Nations which can produce a large amount of goods easily in terms of labor, that is, where the general productivity or efficiency of labor is high, whether due to abundant natural resources, a large supply of domestically owned capital, or whatever the reason, are ones wherein real incomes ordinarily are high. In such nations, where labor is the short factor, goods given in trade represent in general less effort and sacrifice than the goods received.<sup>1</sup>

Those commodities in which a country's productivity is high tend, for this reason, to be abundant and cheap in price compared to those commodities wherein productivity is low. Being cheap in price in terms of other goods and services, such commodities are bought by other countries and provide the efficient country with a supply of foreign currency, thereby enabling it to buy foreign goods. Efficiency, however, does not necessarily mean that the terms of trade are favorable to such a country. If its supply of foreign currency is large in relation to its demand for foreign goods, the exchange rates on foreign countries would be low and it would tend to buy its goods on a favorable basis. If, however, the goods which it produced efficiently and which were cheap, were not in large demand abroad, such country might not have a large supply of foreign currency, with the

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<sup>1</sup> If the high productivity is due largely to foreign-owned capital, the residents of such a country may not have high incomes or much foreign currency with which to buy foreign goods. The foreign owners of the capital might receive most of the benefits of the high productivity.

result that exchange rates and the terms of trade might not be favorable to it. Regardless of the terms of trade, however, an efficient country would tend to obtain its goods, whether at home or abroad, relatively easily and have a high standard of living.

In America the productivity of labor is high, and the supply of most commodities is consequently large. Productivity is high because the laborer is industrious and skilful, is well equipped with tools and machinery, has rich and abundant resources upon which to work—land, timber, minerals, and other resources are plentiful—and because he is in a country where training may be acquired, where production is efficiently organized and where a stable government prevails. Most factors of production are abundant in the United States in relation to labor, and are therefore cheap. The United States is not as densely populated as many other countries, which means that resources and physical wealth in the United States are relatively high per capita. Labor, the short factor, is therefore effectively applied and the output per man is bountiful. The high productivity of the American laborer makes it possible for him to have a large real income—a large amount of commodities to consume, and a high standard of living. Most of the commodities he consumes are made by his fellows who are also favorably situated; others come from abroad and are produced with considerable effort.

In foreign countries where labor is less effectively applied, the output of commodities is less, and real incomes of workers are accordingly lower. If labor were entirely mobile, and were free to move to the countries where production was most efficient and where labor was most generously rewarded, these discrepancies in incomes would tend to disappear, and the standards of living would become more nearly equal throughout the world. Labor, however, is extremely immobile; also, immigration restrictions interfere with movement from country to country. The world is not one of free movement of labor and capital and of perfect competition.

The high productivity and efficiency of the laborers of some countries as compared to those of other countries accounts for the great bulk of the differences in incomes of the people of

some countries in comparison to those of others. This is also true within a country. The efficient persons, wherever they are, obtain a larger share of the social product than the inefficient. As between foreign countries, since some countries have a relatively higher level of productive efficiency than others, they are able in their trade with the rest of the world to give, and therefore to receive or command, a large amount of goods in terms of the expenditures of their effort, but this does not necessarily mean favorable or unfavorable terms of trade.

The high productivity of the laborers of some countries, while beneficial to these workers, is not detrimental to the laborers of other countries. On the contrary, it may be helpful to the peoples of all countries. The good fortune of some laborers is not the misfortune of others. Were it not for the high productivity of some countries, the countries with poorer laborers or poorly equipped laborers might obtain still less in their international trade. For example, because American farm labor is well supplied with tractors and fertile land, the supply of wheat is increased. Wheat becomes cheaper in terms of other goods not only in America, but in China and in all countries. More wheat tends to be offered by America for the purchase of tea, silk, jute, etc. This may or may not result in a change in the terms of trade, but the probabilities are that the terms would shift, at least temporarily, toward more wheat for a given amount of tea, silk, jute, etc. Ultimately, the cheapness of wheat might cause some countries to stop producing wheat and produce tea, silk, jute, etc., with corresponding effects upon the ratios of trade between wheat and other commodities.

† If an increase in efficiency in a particular country applies equally to all goods, and as a result of this equal application the structure of prices remains unchanged (an unreal assumption), there would then be no effect on the terms of trade and no benefit to foreigners, for reasons explained above.<sup>2</sup> High general efficiency would not in itself necessarily affect the structure of prices, and without affecting the structure of prices it would not

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<sup>2</sup> See Chapter 9, p. 155.



affect foreign trade. In real life, however, an invention or an increase in efficiency does affect the structure of prices and results in a cheapening of certain types of goods in terms of other goods. This cheaper relationship of certain goods spreads to other countries thereby benefiting them. The efficiency of American and European manufacturing industries has made a large supply of manufactured goods available all over the world.

A cheapening of production in a particular country of goods that it exports benefits that country in foreign trade in that the goods which it offers abroad represent to it less effort than formerly (or it may have more goods to offer representing the same effort). While a cheapening of production does not necessarily make the terms of trade more favorable or less favorable, such a country will probably in the aggregate be producing and trading larger quantities of its goods. The larger production might have to be traded for foreign goods at less favorable ratios, but since the goods offered are produced more easily than before, such country would still be better off, and would be merely sharing some of the advantages with other countries.

To sum up—the ratios at which goods exchange are influenced by relative physical productivities or efficiencies. An increase in efficiency does not necessarily make the terms of trade either more favorable or less favorable. The more efficient a nation's labor, whatever the reason, the cheaper in terms of effort its goods become to its own citizens, and probably the cheaper certain goods become to foreigners. The more efficient a nation's production, the less effort does that nation have to expend in securing its foreign goods, but general efficiency does not inevitably alter the structure of prices and benefit foreigners. Differences in productivity of labor account for most of the inequalities in the amounts of labor expended upon goods which trade for each other on an equal basis. Differences in productivity, by influencing the supply (demand) of commodities, constitute one of the factors which determine the ratios at which goods exchange.

**International Wage and Price Relationships.**—It is a matter of common observation that prices of certain goods are higher

in some countries than in others, and that living is expensive in certain places, and cheap in others. It is difficult to make accurate comparisons because many of the articles bought and sold are quite different in nature in the different countries—house rents in Europe and in America, for example, are for very different types of houses and for houses with different conveniences.

The prices of goods that move in international trade tend to be approximately the same in all countries, apart from transportation costs and customs duties, provided governmental restrictions, foreign exchange difficulties, and business practices do not create conditions of artificial scarcity here and abundance there. Goods are far from being perfectly mobile and for a variety of reasons do not always flow quickly to the best market. Furthermore, conditions of demand are not the same in different markets, and if goods are to sell at all in a certain area their prices may have to be lower there than elsewhere.<sup>3</sup> In domestic as well as foreign trade it is not uncommon for essentially identical goods to carry different prices directed to different classes of buyers in the same market or in different markets.<sup>4</sup> Nevertheless, there is a strong tendency for goods that can be readily transported to have approximately the same prices all over the world, allowing for the differentials mentioned above. Wheat normally sells for almost as much in Chicago as it does in Liverpool. Coffee costs almost as much in São Paulo as it does in San Francisco or Paris.

No hard and fast line can be drawn between international goods and domestic goods, and a certain article may shift back and forth between the two groups. Furthermore, international goods enter into the production of domestic goods, and vice versa. Moreover, the prices of one group, through substitution and in other ways, affect the prices of the other group. At the same time certain goods are ordinarily produced and consumed domestically while others sell on the world market. The prices

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<sup>3</sup> It is to be noted that conditions of demand tend to be of no significance in determining long-run prices for goods of constant costs, although a given condition of demand may raise or lower prices for goods produced at other than constant costs, according as these are increasing or decreasing.

<sup>4</sup> Under free competition this condition would tend to disappear.

of goods that are more or less inevitably domestic in nature may vary widely from one area to another, due to differences in the abundance or scarcity of the factors of production as well as to differences in demand and in all the elements that go to determine a price. The price level of a country is made up of the prices of all types of goods, domestic and international, and for the reasons mentioned, variations in the level of prices, measured in terms of a common denominator, can and do exist between different areas or countries, although such differences tend to disappear. Thus the cost of living in Venezuela is high, while in Ecuador it is quite low.

In order to measure such differences it is necessary to express prices in terms of a common denominator such as gold, or in fact any currency unit for which exchange rates on other countries exist. Monetary wages in different areas can be compared in the same manner. Gold has been a useful international measure of values, and the different currencies, whether paper, silver, or gold, can all be expressed in gold terms. The paper peso of Argentina will buy, or can be bought by, an amount of gold definite at any given time. Or, any currency unit, such as the pound sterling or the American dollar can be used in the same manner as a measure of value of other currencies. Measured in this way, the price and wage levels of the different countries vary. A given amount of gold or of dollars will buy more in some countries than in others, but just how much is difficult to determine.

It is apparent that comparing wages or price levels in the different nations is not an easy matter, especially in view of differences in the kinds of goods compared. To compare the movements of price levels and wages in the different countries is much simpler than to compare the relative heights of the price levels or wages. It is easy to say, for example, that prices in England declined 5% while those in America declined 7%, but it is not easy to know whether prices in England are 10% lower or 3% higher than in America.

Monetary wages and real wages may show considerable variation, but ordinarily the two tend to conform. If living conditions in a certain locality are unattractive and costly, monetary

wages there may be high, while real wages may not be high. In most instances, however, if monetary wages are low, the probabilities are that real wages are also low, since price levels tend toward equality. Workers that are not very productive, whether the reason be poor resources, inadequate tools, etc., will be likely to receive both low monetary and real wages.

If a country has a low level of monetary wages it is probably the result of low productivity or inefficiency of the workers, although this is not necessarily the case. The level of monetary wages, incomes, and prices, expressed in terms of a common denominator, is affected by the share of the world's gold which the country receives—assuming the functioning of the gold standard, which functioning, however, has rarely been as complete and perfect as the price-specie-flow analysis usually assumed. If a country lost gold due perhaps to a large demand by it for foreign goods relative to the foreign demand for its goods, or due to a tariff against its goods, or whatever the reason, its level of prices and wages would tend to fall. In spite of differences, price levels tend to be equal, and the share of gold which a country receives tends, under the free gold standard, to be that which will keep its price level in substantial equality with those of other countries.

If the gold standard does not exist, the above conditions of a large demand for foreign goods, etc., would cause a shift in exchange rates, that is, would cause a rise in the price of foreign currencies, which would have the same effect of lowering prices and wages, in terms of a common denominator, relative to those abroad. In the absence of the gold standard, exchange movements help to bring price levels of the various countries toward equality.

If a nation produces a particular commodity which for some reason suddenly becomes very much desired by other nations, the immediate effect is for its price to rise as a result of the increased demand. The exports of this commodity then have a greater monetary value, either because the same quantity is exported at higher prices or, what is more probable, greater quantities are exported and at higher prices. Since buying and selling between nations is upon a monetary basis, the foreign

nations, in order to pay for these increased purchases, have an increased demand for the currency of the country whose goods are in demand—that is, for drafts on this country which can be used to pay for the goods bought. Such drafts therefore tend to become expensive or, in other words, exchange rates rise. If the gold standard prevails, exchange rates may go to the point where the nation with the desired commodity tends to receive gold. This is the means by which gold finds its way into a country following an increased demand for that country's goods. If the international gold standard is not in operation, exchange rates, if free, may move in whatever degree is necessary to effect equilibrium.

The level of money prices and wages of a country relative to that in other countries thus reflects, in some degree, reciprocal demand conditions, inasmuch as these conditions help to determine the amount of gold a country has, or in the absence of the gold standard these conditions help to determine the exchange rates. The level of money prices and wages, it will be noted, is also the result of the effectiveness of labor, the extent of resources, capital, and all the factors which combine to determine a nation's output. Monetary conditions within a country, its currency and banking system, inflation and deflation, may cause fluctuations of the price level, but to the extent that such fluctuations are eventually reflected in exchange rates, internal monetary matters become largely of temporary significance in their effect upon a country's relative level of prices and money wages.<sup>5</sup>

Low wages, monetary or real, do not necessarily indicate low costs, nor a low price level for commodities in general; nor do high wages necessarily mean a high price level. Wages in a country may be low because of poor productivity of the laborers, or because of a very large population in relation to physical wealth and resources, which makes it necessary for labor to cultivate poor soil and work hard for what it produces. Inefficient or ineffective labor, even though low-priced, obviously does not lead to low costs of production and low selling prices.

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<sup>5</sup> For a discussion of the theory of purchasing power parities and the reflection of price level movements in exchange rates see Chapter 13.

Labor costs may be high even though a worker's time be bought for little money.

In India, China, and other oriental countries wages are low, both real wages and money wages. The labor is, on the whole, poorly equipped and trained and therefore ineffective compared to that in certain other countries. It is ineffective, in an absolute sense, even in producing articles which are exported abroad and sold against world competition. But it is less ineffective in producing those articles exported, silk, jute, tea, etc., than it would be in producing automobiles, steel, and manufactured goods, which are imported. In a word, it is relatively effective in the former articles, silk, jute, tea, etc. It is becoming less ineffective, moreover, in the absolute sense, as industrialization proceeds and capital equipment expands.

In spite of a low level of wages in countries such as India and China, the commodity price level there may not be low; in fact, it may even be high. While certain articles of food and the cost of living may be low because of the large number of local goods into which cheap labor enters as an important cost, the cheapness of these goods may be offset by the expensiveness of many imported and other articles, by the ineffectiveness of labor, and by other factors. In China those Americans who live largely upon native products find the cost of living low, while those that live in a metropolitan center, such as Shanghai, and who drive an American automobile with American gasoline and consume other imported products find the cost of living high.

While money wages and real wages are relatively high in America, many articles here are extremely cheap, as evidenced by the fact that American goods compete successfully all over the world. Prices in America often seem higher than they are, because of differences in quality between American and foreign goods and because the high rate of money wages in America makes labor services expensive. To the extent that the effectiveness of American labor, which makes exported goods cheap, prevails also in the production of domestic goods, these domestic goods are also cheap. Therefore, in spite of a high rate of money and real wages and high prices for labor services, the

level of all commodity prices in America is probably not high in comparison to foreign countries.

**Terms of Trade and Price Level Relationships.**<sup>6</sup>—In discussing reciprocal demand it was said that if a country produces goods which are in large and urgent demand from other countries, in contrast to its own demand for foreign goods, it would tend to obtain goods and services upon a favorable basis or ratio of trade. It could then command a large amount of goods in return for its exports and thereby draw to itself a good portion of the benefits of international trade. The mechanism by which the terms of trade are established is the interaction of many forces working toward a general equilibrium. They are reflected in prices and exchange relationships and movements.

It is through commodity prices and the price system that equilibrating forces find expression. If one bushel of wheat is to trade for ten yards of cloth, the ratio of one to ten is determined fundamentally by the quantities of wheat and cloth available, that is, the supply, and by the demands for those goods, as already discussed. The supply (demand) of an article, it will be remembered, is determined essentially by the difficulties of production, the effectiveness of productive efforts, and the nature, intensity, and extent of consumers' desires for this and all other articles, individually and collectively. The ratio is thus to be explained fundamentally in terms of the theory of value; the ratio, in fact, is value.

The prices of individual articles in any country express the ratios at which these articles are traded one for the other, measured in terms of a common denominator, money. As already noted, they are part of a system or structure of prices. Money is the measuring stick for the market value of goods; and the value of money, its purchasing power, determines whether the equivalence of one bushel of wheat to ten yards of cloth is stated as a price of \$1 for a bushel of wheat and \$1 for ten yards of cloth, or as \$2 for the wheat and \$2 for the cloth. If two dozen eggs are equal to one pound of butter, the prices might be 30 cents a dozen and 60 cents a pound, or 50 cents a dozen and \$1

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<sup>6</sup> See also Chapter 13.

a pound. Prices thus express nothing but ratios between goods and the ratio between goods and a unit of money.

While all prices do not rise and fall together, they tend to do this, so that if the level of prices rises, the prices of all individual articles tend to rise. In the above illustration eggs might rise to \$1 a dozen and butter to \$2 a pound. A rise in the price level is merely another way of referring to a rise in the average price of all articles. During such rise, or fall, however, the individual prices do not stay in exactly the same relationship although they tend to do so. In fact, prices never stay long in the same relationship, and in a dynamic economy are constantly changing.

Changes in the price levels of the various countries (measured in terms of gold or some other common denominator) influence, in the short run, the terms of trade and the sharing of the benefits of trade, that is, whether a bushel of American wheat trades for nine yards or ten yards of British cloth. If the price level in the United States rises while that in Great Britain falls, the trade between the two countries is affected. In the United States, money wages and incomes would tend to rise along with prices, while in Great Britain they would tend to fall. The United States thus would have more monetary income with which to buy British goods, which would now be cheaper, assuming exchange rates are unchanged. Great Britain, on the other hand, would have less monetary income to buy American goods, which would be more expensive. If Great Britain wanted to buy the same physical quantities of American goods, which now had higher values, she would have to send larger quantities of her goods to bring about a value equivalence in the trade. If exchange rates between the two currencies were flexible and became completely adjusted to this new price situation, trade would then tend to be conducted at the former quantity ratio, inasmuch as the former price level relationship would then maintain. In the long run this adjustment would tend to take place and price level relationships would be restored, other things being equal.

Articles which have an international market and which are objects of international trade, as already mentioned, tend to be



the same in price in all countries—with many and important exceptions which prevent the tendency from being realized. At the same time, a nation with a high level of commodity prices and monetary incomes buys its imports at prices which to it are cheaper because of its higher monetary incomes. It buys its imports on the world market and at the same prices which nations with low monetary incomes must pay.

A higher price level may result from a large foreign demand for a country's goods. For example, assume first that gold is allowed to flow and to influence internal prices and that exchange rates are fixed. If a nation is in the favored position of having other nations urgently wanting large amounts of its goods, and if perhaps also its desire for their goods is not especially strong so that it is not buying much, it will tend to receive gold from other nations in payment for their purchases.<sup>7</sup> The gold coming in tends to raise the level of commodity prices, and at the same time to lower the price level in the country or countries which exported it, unless these tendencies are counteracted by currency control devices. The country receiving gold tends to have a higher level of monetary incomes, while the countries which lost gold have lower levels of monetary incomes. The favored country now finds foreign goods cheaper and is induced to buy more, while the other countries find its goods more expensive and tend to buy less. This process continues until an equilibrium is established between goods and services coming in and those going out, so that the goods coming in are sufficient, without gold shipments, to pay for the goods going out. The goods which the favored country exports are now being paid for by the goods imported, and the trade is in balance.

At the same time the price levels of the countries involved have been altered, and a new relationship established. This fact permits the country whose goods are wanted urgently by others to conduct its international trade upon a more favorable basis as regards the quantities exchanged. Equilibrium is established, or approximated, and gold movements checked at the point

<sup>7</sup> Under exchange stabilization systems, stabilization fund administrators would find exchange rates on such a country tending to rise, so that they would probably arrange for gold shipments to that country or would make payment to it by reducing their foreign balances.

where the monetary value of the goods exported tends to equal that of the goods imported. This process of bringing it about that imports and exports pay for each other also brings about a change in monetary incomes, raising them in the country of higher prices and lowering them in the country of lower prices. The change in prices and monetary incomes alters the ratios at which goods are traded. It is possible, however, that high prices and incomes may be the effect of favorable terms just as much as the cause. The process is one of interaction, and may, therefore, just as logically be stated the other way round, namely, that changes in the ratios or terms of trade alter price levels and incomes.

In the above illustration it was assumed that gold was allowed to flow and that price level changes ensued. In recent years this type of situation has not existed anywhere in the world; in fact, it has seldom existed except imperfectly. Assume, therefore, that the countries in question are not upon the gold standard, do not have fixed exchange rates, and that gold does not come into the picture to help bring equilibrium in the balance of payments. Adjustments then would come about largely through changes in exchange rates. Drafts on the country which had a strong demand for foreign goods would become plentiful and cheaper, and exchange rates on that country would fall. Its goods would accordingly become cheaper to other countries. On the other hand, drafts on the country which had small demands for foreign goods would become scarcer and more expensive, so that this country would receive a larger amount of foreign currency in exchange for its own currency. This shift in exchange rates means that it would receive a larger amount of foreign goods in exchange for its own goods.

In the event that gold is allowed to flow but is not permitted to influence prices because of internal currency policies—a condition which existed in the inter-war period—exchange rates must eventually be altered to adjust to trade and balance of payment conditions, as discussed in Chapters 13 and 14. Stabilization fund operations or other types of exchange control may defer this, but if the balance of payments continues heavily one way or the other, exchange rates will eventually have to

give way. While price level differences may exist between countries, the world integration of prices and trade (under reasonably free trading and exchange conditions), tends to bring price levels toward equality.

It might appear that since exports must equal imports in value (including invisibles) the gain of having high monetary incomes with which to buy goods produced in low price level countries, is canceled by the loss of being required to sell also in those low price countries. This, however, is not the case. The costs of producing the articles exported by the high price level country, and the costs of those imported from low price level countries, must be taken into consideration and compared. In the first country costs are based upon a high level of prices and incomes. If other countries want to buy goods of the high price country they must pay prices which are adjusted to the higher monetary costs, costs which are higher than would be the case if a low price level prevailed. The higher costs include higher monetary incomes. Goods which are contributed by such a country to the world's market are only those goods which can be contributed on the basis of the country's higher price level, involving higher costs and also higher monetary returns. The country will not export unless the foreign selling prices, converted into the country's own currency, allow for the higher costs of production. The high price country, if it is to export, must adjust its selling prices to the world market, or vice versa. To put it another way, if the world wants such a country's goods the world must raise the selling prices of these goods sufficiently high to attract them. Thus a high price level reflects favorable terms of trade, or, as noted above, favorable terms may be reflected in a high price level.

When the high price level country buys goods produced in low price level countries, the goods bought are produced at costs which tend to be lower than would be the case if the general price level there were higher. The selling prices of such goods are correspondingly adjusted to lower costs, so that a country with high monetary incomes has an advantage in trading with such a country. All these situations are, of course, influenced by whether costs are of an increasing or decreasing nature.

The monetary incomes of a country are the result primarily of two sets of conditions: first, the effectiveness in a broad sense of its productive efforts, and second, monetary factors which determine the level of prices. High monetary incomes may be due only to a slight extent to a high price level, but be due principally to efficiency in production. High monetary incomes would then represent high real incomes. High incomes because of efficiency in production, of course, do not mean high costs of production, as already pointed out—in fact, they mean the reverse. It will be noted that a country of high monetary incomes, such as the United States, is not necessarily a country of high prices in general. Many things are much cheaper here than abroad, as automobiles and other manufactured articles.

**Exchange Depreciation and the Terms of Trade.**—When a country depreciates its currency in the foreign exchange market in order to gain a trade advantage for its exporters by making the country's goods cheap abroad, this advantage continues only so long as internal costs and prices do not rise correspondingly so as to offset this apparent cheapness. Foreign exchange depreciation is usually accompanied by internal currency depreciation, i.e., rising prices, unless exchange rates were previously out of line with internal prices. Continuance of the stimulus to export industries from depreciated exchange is thus dependent upon a greater or more rapid depreciation in exchange rates than the rise in internal commodity prices. When the rise in prices is very rapid, foreign exchange rates have usually anticipated such internal depreciation and have depreciated first, so that a lag frequently exists in rising prices over exchange depreciation and causes the country's goods to be cheaper abroad. Exports are thereby stimulated. When the Japanese yen became depreciated in terms of gold in 1932 and 1933, the prices of Japanese goods became cheaper to other countries since prices in Japan did not immediately rise correspondingly with the depreciation in exchange. Under such conditions, however, imported goods become more expensive as foreign drafts rise in price.

A forced depreciation of exchange rates, such as took place extensively during the early 1930's, creates an imbalance in a

nation's foreign payments and receipts, assuming exchange rates were previously approximately at a stable equilibrium level. When fixed exchange rates exist and are out of line with price level relationships and other conditions, as in the case of France in 1936, a depreciation of exchange may then bring rates more closely toward this free equilibrium level.

From the standpoint of the country as a whole, and in terms of quantities of goods given and received, a net loss is suffered by exchange depreciation brought about for the purpose of stimulating exports. The terms of trade move unfavorably for such a country.<sup>8</sup> Since foreign currencies cost more, the country is paying higher prices for what it buys abroad. It is giving more of its own currency for the same amount of foreign currency, and because of the lag in the rise of internal prices behind the rise in exchange rates foreigners are able to obtain more of the goods of such a country than before. The country is thus selling its goods relatively cheaply in terms of foreign goods. The export industries, of course, enjoy good profits and the country on the surface may appear prosperous. On a monetary basis imports may be large because of the higher prices paid for them. Imports may also be stimulated by the larger exports. On a quantity basis, however, the ratio of goods traded becomes less favorable.<sup>9</sup> Furthermore, the situation causes maladjustments in such a country's industries and general economy. If the exchange depreciation is the result of causes other than internal price depreciation, such as capital movements, the unfavorable shift in the terms of trade may persist as long as the cause remains.

In the clearing and other bilateral agreements which Germany negotiated prior to the war, exchange rates were sometimes set at a level intended to encourage German exports, and therefore resulted in unfavorable terms of trade to Germany. After the outbreak of war, Germany's agreements forced on the

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<sup>8</sup> For a statistical study of the loss to Germany in her trade with Brazil as a result of the depreciation in the external value of the mark, see J. Richard Huber, "Bilateralism in Foreign Exchange Control," *Proceedings of the Nineteenth Annual Conference of the Pacific Coast Economic Association*.

<sup>9</sup> Cf. Willford I. King, "Recent Monetary Experiments and Their Effect upon the Theory of Money and Prices," *Journal of the American Statistical Association*, June, 1935.

occupied countries greatly overvalued the mark and consequently resulted in terms especially favorable to Germany.

An expansion in exports, however, due to exchange depreciation or to whatever reason, tends to increase the national income, and thereby to offset to some extent the loss from unfavorable terms of trade due to a shift in exchange rates. The expansion in exports means an increase in the money expenditures necessary for their production, and therefore in the national income. The national income may increase by an amount greater than the original expansion in expenditures due to the fact that the money expended for the additional exports is respent for domestic goods, and thereby leads to a further increase in production. This tendency is referred to as the foreign trade multiplier. A necessary condition is, of course, a level of activity below full employment.

## CHAPTER 12

### MONEY, PRICES, AND TRADE

**Monetary Basis of Trade.**—International trade, like domestic trade, is conducted in terms of money. An export or import is so many dollars' worth of cotton, so many pounds' worth of steel, or so many francs' worth of lace. The economic systems of all nations are thus organized upon a monetary basis.

Whether a sale be stated in terms of United States dollars, British pounds, Russian rubles, or Mexican pesos has, of course, little fundamental significance. It has come about, however, that certain units are used more extensively in international trade than others. Thus the dollar and the pound are special favorites, even for transactions in which neither the United States nor Great Britain is involved as buyer or seller. This is largely because of the dominant financial position of these two countries, and the facilities which they offer.

The number of different monetary units in the world increased greatly as a result of the first World War. In 1913 there were only ten really distinct currency units in Europe, while after the rearrangement of borders there were more than twice this number. In addition to the new countries with new units, several of the old European countries formerly had identical units which circulated across borders, but which were distinct units after the war. Thus as a result of the so-called Latin Monetary Union, France, Belgium, Italy, and Switzerland all had currency systems based upon a gold unit worth 19.29 cents in American money. The unit was called a lira in Italy and a franc in the other three countries. The denominations and sizes of the coins were alike, although the insignia differed. The coins of each country circulated freely in all of the countries. Similarly, as a result of the Scandinavian Monetary Union, the three Scandinavian countries had identical units

which circulated interchangeably in each of these countries. After the war no two European nations had similar units.

The units of South America and of some of the smaller countries of the world have never been used as extensively in foreign trade as have the principal European currencies and the American dollar. Prior to the outbreak of the second World War, quotations for from 30 to 40 of the world's currencies were shown daily in most large newspapers, but the great bulk of the trade between nations has always been transacted in terms of only a few of these units.

**Currency Problem International.**—The currency problem of a nation cannot be separated from international affairs. Great Britain was driven off gold in 1931 by events outside her borders. A train of international events followed and other nations were forced to abandon gold. The currency problem is international in nature and scope, especially from the standpoint of the world-wide effects of currency disorder and instability, and of methods of attaining desired economic stability. Currency matters have much to do with promoting greater world production, trade, and economic progress generally.

No nation has escaped currency fluctuations and their ravaging effects. In 1920 the United States dollar would buy considerably less than half what it would purchase in 1914. In May 1920 about \$247 were necessary to buy what \$100 would buy in 1914. This depreciation of the dollar is usually referred to as a rise in the general price level. Even though the dollar was depreciated and would buy fewer commodities in America, it would purchase in the New York exchange market a larger amount of European currency than before. While the general level of prices in the United States had more than doubled during the six-year period, prices in Europe had gone up very much farther.

Currency depreciation in European countries during and after the war was much more extreme than in the United States. Prices in Europe went skyrocketing, in some cases to fantastic heights, with almost complete disorganization of economic life. Although the people in Europe during and after the war suf-



fered greatly from currency depreciation, few of them had more than vague ideas as to the causes of the trouble. If a man on the street were asked why the money had so little value, the answer might be "the government is weak and has a big debt," "the banks have no gold," "people do not trust the government," or merely "*la guerre*." Occasionally, the answer would be that there was too much paper money.<sup>1</sup>

The foreign exchange or external value of a currency, although determined immediately by the demand and supply of bills on that country, is based to a large extent upon that currency's internal value. By this we mean that the demand and supply of bills of exchange upon a particular country are influenced by how much the currency of that country will buy, i.e., how many commodities can be bought in England with 1,000 pounds, or in France with 1,000 francs. Market rates of exchange thus reflect, among other things, the purchasing power of a country's currency, or, in other words, the price level prevailing in that country.

Monetary matters play such a central rôle in economic life that without an understanding of currency principles it is impossible to understand international trade theory or current international economic affairs.

**Value of Money.**—The outstanding purpose of a currency is to facilitate the exchange of commodities, and to serve also as a standard or unit in terms of which values can be measured and expressed. Instead of saying that a bushel of wheat costs three dozen eggs, the values of both are measured in terms of dollars and cents and are said to be, for example, one dollar, or whatever price happens to prevail. Without the help of money, trade would obviously be very restricted, and economy reduced to a primitive state of affairs. Barter has so many inconveniences and interferes so much with the development of trade, that even the most primitive civilizations adopted some well-recognized article such as skins, weapons, or shells, which passed as money, and which became a standard for measuring

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<sup>1</sup> These answers were given the author by taxi-drivers, waiters, hotel clerks, business men, bankers, and government officials.

all values. Monetary evolution finally singled out the precious metals—silver and gold—as the most useful articles for this purpose. Most countries until recently were upon the gold standard or a form of this standard.

The precious metals embody a relatively large amount of value in compact and easily transportable form. They are easily divisible into any desired amounts and do not deteriorate to an appreciable extent by age. These qualities have made them useful as money for many centuries. These metals, however, have a serious shortcoming in the lack of adaptability of their supply to business needs, that is, to the demand for money.

The fact that an article which comes to be regarded as money is acceptable by everybody, and therefore can readily be passed on to someone else, is the distinguishing characteristic of money. As long as an individual is confident that he can pass on a piece of money to someone else in the purchase of an article or of a service, it has value to him. When he knows he can pass the money on, it has value to him even though the money be only a piece of paper, even though he knows nothing of what is behind it, or if anything at all is behind it, and even though he knows it will never be redeemed. Money thus obtains its value, not by the value of the material of which the money is made, but by the fact that the money has come to be regarded as “money,” and is readily accepted by all parties.

The reason that an article, which may be worthless in itself, possesses this quality of general acceptability, is usually that the public has the belief, often quite vague, that the government or some bank is behind the money, that the money will perhaps be redeemed sometime in something. This ordinarily is the case, although instances have been cited where paper money continued to circulate after the government had disappeared and when there was nothing behind the money and practically no prospect of ultimate redemption. The public needed a medium of exchange, and as long as the money could be passed on to a third person and was limited in quantity, people did not hesitate to accept it. Ordinarily, however, in the background behind acceptability stands a government, a bank, or some authority. The specific arrangements regarding the

security or backing of money vary from country to country, and range all the way from little or nothing up to 100% in gold.

When public confidence in the issuing authority is weakened, the general acceptability of money may be impaired. An individual may become apprehensive that he may not be able to pass on the money for full value. Experience has shown that such lack of confidence seldom leads to complete rejection of the money. Money will continue to circulate, since the public must have a medium of exchange, but perhaps at reduced values. It usually circulates more rapidly under circumstances of weakened confidence. While the acceptability of money may rest ultimately upon subconscious confidence on the part of the public in the issuing authority, under ordinary circumstances the credit of the issuing authority has little relation to the value at which the money circulates.

The fact of general acceptability explains why money has value, but does not explain why the value of a particular piece of money is just so much, why a dollar will buy just so many commodities and no more, and also why the value of money changes from time to time. The so-called quantity theory of money has long been used to explain the value of money, or the level of prices. This theory in its narrow classical form is inadequate, particularly for present-day highly developed financial conditions. It is, therefore, sometimes said to be obsolete. Interpreted, however, in the light of modern conditions, it goes far to explain price movements and the value of money. It is the cornerstone of present-day monetary policy of most nations.

It is common knowledge that the value of any article depends more or less upon the amount or supply of the article available in relation to the demand for it. If the supply of wheat becomes abundant, the value tends to fall; if it becomes scarce, the value tends to rise. On the other hand, if the demand falls off, the value tends to decline; while if the demand increases, the value rises. The value of any commodity is the resultant of these two forces of demand and supply. This, however, is only a partial explanation. We must know what the factors are which determine demand and supply, the many factors that lie

behind these forces. Why is demand what it is, and why is supply what it is? The factors behind demand and supply include such things as consumers' tastes and desires, and the difficulties of producing goods; these difficulties are determined largely by the extent of natural resources and productive equipment which are available to produce goods and offer them on the market.

The law of demand and supply applies to the value of money as well as to that of commodities. In a simple economy the amount of value attaching to each monetary unit is determined to a large extent by the relative number of these units in existence. If there is a large amount of money the value is low; if a small amount the value is high. What is meant by a "large" amount of money? The amount or supply of money is to be related to the need or demand for money as money, which is determined by such things as the size of the population, its production, the amount of business to be transacted by money and the desires for money to keep merely as "ready money."

The demand for money in the sense of wealth or the things which money will buy is well-nigh unlimited, but this is not a demand for money itself, except as a temporary means to an end. We must distinguish between money and wealth, the latter being things which money will obtain. A very wealthy man may require only a relatively small amount of money. If a person were given a million dollars he would soon convert most of this into forms other than money. The amount of cash he retained on the average would represent his demand for money.

The demand for money, it will be seen, therefore, is determined by the volume of transactions to be consummated by the payment of money, together with the desires and habits of the public with reference to the use of money, such as the length of time people hold money before spending it, and the extent to which they hoard money. Everybody desires to maintain a certain portion of his assets in the form of cash, partly in his pocket but mostly in the bank. This represents his demand for money. The demand for money is thus affected by the extent to which people desire to maintain their wealth or assets in the

form of money itself as opposed to other forms such as physical things.

The degree of liquidity or the extent of the cash position which people desire to maintain, fluctuates from time to time. This attitude has been referred to by John Maynard Keynes as liquidity preference, and, it will be seen, affects greatly the demand for money.

If for some reason the attitude of the public changes and people desire to hold larger amounts of cash, perhaps through fear of depression, the demand for money has then increased. The demand for money fluctuates and is influenced by such things as the volume of production, business confidence, the outlook for the level of prices and prospects regarding profits. The rate of spending, that is, whether money is held long or spent promptly, is changing constantly in response to political and a variety of other conditions. A speeding up of spending is a reduction in the demand for money since it means people are preferring goods to money. A speeding up of spending, it will be noticed, tends to increase business and incomes all along the line.<sup>2</sup>

If there is a large population and a great amount of business, and yet only a small quantity of money to do this business, that is, a small supply in relation to the demand, the money will be hard to get and its value will be high. On the other hand, if there is a plentiful supply of money so that people tend to have large amounts of it, the value of the money will be less. The value of money, that is, the amount of goods which each unit of money will purchase, is thus determined by the interplay of demand and supply. These are represented on the one hand by the quantity of goods being offered for sale, or the amount of monetary transactions to be consummated and the effective demand for cash, and on the other hand by the quantity of money available to do this work. The supply of money, however, is not a fixed amount but changes in response to demand and other forces, as noted below. The more currency a country

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<sup>2</sup> A speeding up of spending may result in additional borrowing and thereby the creation of new money. A decrease in demand may thus increase the supply and hasten the decline in value, or the rise in prices.

has in general the cheaper this currency becomes, unless additional business, increased population, or a greater demand for cash balances accompany the increase in money. The rapid depreciation of the German mark after the first World War, following additional issues of mark notes, showed the effects of increased issues of money without a corresponding increase in the need for money.

The currency of a country is continually being spent, some kinds more rapidly than others. When people have more pocket cash than is necessary for their customary purchases, they put it in the bank or invest it. This, however, does not necessarily mean that the money will not be spent, because the bank may loan it to someone else to spend. If the owner of the money invests it, it may be spent for the building of a factory, for paying wages, or for some other purpose.

The amount of money that is spent during a given period of time is obviously equal to the amount of goods bought (or sold) multiplied by their respective prices. This is a simple mathematical fact. For example, if \$1 is spent and ten loaves of bread are bought, the price is 10 cents a loaf. If \$100 are spent for 100 bushels of grain the price is \$1 a bushel. This may be expressed in the form of an equation as follows:

$$\begin{aligned} \text{Amount of money spent} &= \text{Goods sold} \times \text{Price of these goods, or} \\ \$100 &= 100 \text{ bushels} \times \$1 \text{ a bushel.} \end{aligned}$$

It follows that, if there is an increase in the amount of money and this money is spent while the amount of goods bought remains the same, each article must sell for more money. A greater amount of money is being directed toward the purchase of the same quantity of goods, and the prices of these goods rise. If the new money is not spent but remains idle, it, of course, has little effect. Whether or not money is spent or held has very important effects on business conditions and the entire economic system. If additional goods are produced for sale (which usually happens to some extent when new money is created), prices may not rise very much until the increases in money more than offset the increases in goods. A rise in prices caused by new money—a decline in the value of money—

ordinarily takes place through increased buying as the new money is spent. There exists a so-called seller's market when sellers are able to obtain higher prices due to a greater demand for their goods and less keen competition among the sellers. The mere anticipation of rising prices may stimulate buying and thereby bring a rise in prices prior to any actual increase in money. This involves greater activity of the existing money.

The number of times a piece of money is spent during a given period, its rate of turnover or velocity reflects the demand for money, a slowing down being the result of an increased demand. An increase in demand has practically the same effect upon prices as a decrease in supply. From the standpoint of money offered there is little difference whether during a given period a certain dollar bill is spent four times in buying goods, or whether four different bills are each spent once and remain idle the rest of the time. In the first instance the bill is doing a larger amount of monetary work, but in either case the same amount of money has been offered for goods. In the above equation a single dollar spent 100 times ( $\$1 \times 100$ ) would give the same result as though 100 dollars were each spent once in buying the 100 bushels. Thus the rate at which money circulates, its efficiency or velocity of turnover, is a factor in the determination of the value of money, or the price level. This velocity, as already noted, is a reflection of a great many conditions, and has important consequences upon the economic system.

Small coins circulate more rapidly than do large coins. Studies have shown that the rate at which money turns over varies with business conditions. In periods of business depression, hoarding and other factors slow down the rate of turnover, so that a large volume of money outstanding may not mean a rise in prices. The large volume may be offset by an increase in demand for money as represented by the slower turnover. Much of the money may have even a zero rate of turnover. In periods of prosperity the rate of turnover tends to increase and may lead to a rise in prices. When people are suspicious of money or of a government's monetary policy and expect that money may lose some of its value, they consequently

are inclined to spend it quickly. The effect of this decrease in demand for money is the same as though the supply of money were increased. Thus in the spring of 1933 the public expected prices in the United States to rise, that is, for money to lose some of its value. For various reasons they preferred goods to money. The rate of turnover increased and prices rose in spite of the fact that the volume of money was declining. This explains also why, during periods of extreme inflation in Europe, a new issue of money sometimes caused a greater rise in prices than its absolute amount warranted. Lack of confidence in money speeds up the rate of circulation and means a decrease in demand, or the equivalent of an increase in effective monetary supply. Lack of confidence in business, however, and poor prospects for profits slow down the rate of circulation and cause an increase in the demand for money. These conditions cause people to maintain larger cash balances.

**Paper Money and Its Redemption.**—From the standpoint of the value of money, it makes practically no difference of what material the money consists, whether paper or metal. The relative amount or quantity of money available is, in the long run, the important factor. David Ricardo, writing more than 100 years ago, said:

. . . by limiting the quantity of coin, it can be raised to any conceivable value.

It is on this principle that paper money circulates. . . . Though it has no intrinsic value, yet, by limiting its quantity, its value in exchange is as great as an equal denomination of coin or of bullion. . . .

On these principles it will be seen that it is not necessary that paper money should be payable in specie to secure its value; it is only necessary that its quantity should be regulated. . . .

Experience, however, shows, that neither a state nor a bank ever have had the unrestricted power of issuing paper money, without abusing that power: in all states, therefore, the issue of paper money ought to be under some check and control; and none seems so proper for that purpose as that of subjecting the issuers of paper money to the obligation of paying their notes, either in gold coin or bullion.



A currency is in its most perfect state when it consists wholly of paper money, but of paper money of an equal value with the gold which it professes to represent. The use of paper instead of gold substitutes the cheapest in place of the most expensive medium, and enables the country, without loss to any individual, to exchange all the gold which it before used for this purpose, for raw materials, utensils and food. . . .<sup>3</sup>

In the above quotation Ricardo gives some of the fundamentals of currency theory, although his simple statement emphasizes supply as opposed to demand and falls short of explaining present-day currency, price, and other economic movements. A highly developed financial society, such as we have today, could not have been provided for in the thought of his day.

In the United States prior to March, 1933, all paper money was redeemable in gold upon demand. Gold certificates were specifically backed 100% by gold, but the rest of the money had behind it gold only to a fraction of its face value. Few persons cared to have gold, but the Federal Reserve Banks maintained a gold reserve to redeem such money as might be presented. The responsibility of redeeming money in gold provided, as Ricardo pointed out, an ultimate check against an overissue of paper money. When this barrier was removed in the United States in 1933, many persons feared excessive issues of money. In fact, President Roosevelt vetoed a paper money inflationary bill which actually passed Congress. A large increase in money took place in the years following, yet prior to the outbreak of war no great increase in prices resulted, largely because of an increase in the demand for money, or in other words, a slowing down in the rate of circulation, together with an increase in the volume of business.

When the European governments increased their issues of paper money during the first World War, they were forced to suspend the privilege of redemption in gold. They suspended in anticipation of large demands for redemption. As the new money became more abundant, its value declined and became less than that of the gold it represented. If the governments,

<sup>3</sup> David Ricardo, *On the Principles of Political Economy and Taxation*, Ch. XXV, First American Edition, 1819.

or banks, had been forced to maintain redemption, they could not have issued so much paper money. Redemption, it can be seen, provides a crude method of controlling the quantity of money, but does not provide for a "proper" adjustment of the amount of money to the needs of the community. What a "proper" adjustment is and what are the methods of attaining it are among the most difficult and debated questions in the realm of monetary administration.

Silver money in the United States, and in all but silver standard countries, is worth as silver only a fraction of its face value. The value of the silver in American silver coins may become very low because of a low price of silver, and yet the value of the coins is not affected. Silver money is not very different from paper money in that both are fiduciary. The material from which the silver money is made, however, is worth something, and provides a check against extreme depreciation, while the material from which paper money is made is worth almost nothing. They both have a monetary value or purchasing power in excess of that of their constituent material, and not determined by it.<sup>4</sup>

Whether the monetary supply of a country consists of paper, silver, or gold makes little difference from the standpoint of value. The important question in regard to the price level, or the purchasing power of the money, is that of the total amount of money outstanding in relation to the transactions to be effected by means of money and other demands for money as discussed above.<sup>5</sup>

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<sup>4</sup> Experiences of China show what happens when subsidiary coins are issued in excess and are not redeemable in standard money. Until a few years ago in China, approximately eleven dimes and a few coppers were required to make one standard dollar.

<sup>5</sup> Gold and silver have usefulness as commodities aside from their usefulness as money. The commodity use of a metal does not affect its value as a piece of money, except in so far as the commodity use may increase or decrease the amount of the metal in monetary channels. Commodity uses may consume a large amount of the metal and thereby reduce the amount of the metal in monetary channels, or vice versa. If the commodity or non-monetary uses of gold, for example, become more urgent and out-bid the monetary uses (the value of such uses is measured by the amount of goods which the gold money will buy) more of the new gold goes into non-monetary channels. The supply of money is thereby less than it would otherwise have been. The value of money accordingly tends to rise, which means that the price level tends to fall. The value of the metal gold, it will be noted, affects the value of gold coin only by increasing or decreasing the supply of money.

The value of money which is redeemable in gold obviously cannot be less than the value of the gold which can be obtained for it. The value of the com-

**Bank Credit and the Price Level.**—In countries like the United States and Great Britain bank checks are used in making purchases in the same way as money. In fact, in the United States the great bulk of purchases are paid for in this manner. Estimates of the amount of business in the United States transacted by check vary from about 85% upward (referring to total value rather than to individual transactions).

In considering the total monetary supply of a country, bank deposits which are checked against should therefore be included along with hand-to-hand money. A bank deposit or "money in the bank," it is to be remembered, does not consist of physical money. Banks do not have enough cash to pay all their depositors at once. Bank deposits are a part of that intangible thing called bank credit. Even though deposits are not part of a country's physical currency, they are nevertheless used the same as money and are part of the effective monetary supply, in fact, the major part. They circulate by check from person to person, and have a very important influence upon a country's level of prices. Hand-to-hand money, paper or coin, plus bank deposits which are subject to check constitute a nation's monetary supply, or its total amount of purchasing media.<sup>6</sup>

As a coin is spent over and over again and used many times during the course of a year, so bank deposits are used many times in making purchases. For example, Jones will make a payment to Smith by handing him a check. Smith will deposit it in the bank and in a few days draw his own check against it and pay Brown, who will in turn deposit it and later draw against it. Bank deposits must therefore be multiplied by the average number of times which they turn over during a given

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modity gold is determined on the same principles as that of anything else, namely, according to the demand and supply of gold. Since gold shifts from the arts to monetary uses and vice versa, and since new gold can go into either field, the value of gold as bullion and as money is always practically identical. The monetary demand for gold is only one of the demands for gold, but it is one of the most important demands and consumes the major portion of new gold. The monetary demand therefore helps to determine in a very important way the value of gold as a commodity. Were it not for monetary uses of gold, gold would be much less valuable. The value of gold as a commodity in turn helps to determine the amount of gold allocated to monetary uses, since if commodity uses bid strongly for gold, monetary systems receive less gold. In recent years in view of the large amount of currency management, the value of gold has been controlled to a considerable extent by the monetary system, rather than the reverse.

<sup>6</sup> A substantial amount of goods is bought on open account or on the installment plan and do not require an immediate monetary payment.

period, in order to determine the extent to which they serve as money and influence the price level.

The principal factors which enter into the determination of the value of money as just discussed are commonly stated in the form of an equation with the following symbols:<sup>7</sup>

$$MV = PT$$

*M* stands for the total amount of all forms of *money* or the total purchasing media;

*V* stands for the *velocity*, or rate of turnover of this money;

*P* stands for the average, or level, of all *prices*;

*T* stands for *trade*, or the physical goods or services traded by means of money, i.e., business transactions that require the passing of money.

This equation is, of course, not the quantity theory of money; it is merely a statement of equality and does not explain the size of the different items nor what motivates changes in these items. Moreover, it says nothing regarding which factors are causes and which effects. It does indicate, however, that if a change is made in *M*, some other factor must change also to compensate. Experience indicates that an initial change can originate, or be reflected, in any of the items. If more money is put into circulation, the velocity of monetary circulation may slow down and little change in prices take place. Ordinarily, however, an increase in money or bank deposits, that is, *M*, tends to find expression in an increase of prices, although this may not be the immediate effect.

An expansion of money (or deposits) may stimulate the turnover, as people anticipate higher prices because of the expansion and therefore spend more freely. The additional purchases (a reduction in the demand for money) would, at the same time, probably increase the volume of production and trade, so that prices might rise only slightly. In 1935 and 1936 in the United States, increases in deposits accompanied rapid increases of production and trade, and the price level remained relatively stationary. If the public expect inflation of the mone-

<sup>7</sup> Cf. Irving Fisher, *The Purchasing Power of Money*, New York, The Macmillan Co., 1925.

tary supply and consequently higher prices, they tend to spend more freely, preferring to own things rather than money, and prices may rise without there having been any increase in the amount of money, although the velocities will, of course, increase. This was the situation in the United States in the spring of 1933, when after the bank holidays prices rose sharply at a time when the volume of currency was declining and when bank deposits remained practically unchanged. A speeding up of spending may result in additional bank borrowing and therefore the creation of new deposit money. A decreased demand for money may in this manner lead to an increase in the supply of money, and hasten the decline in value of money, or the rise in prices.

As money is spent and respent it passes from consumers to retailers, to wholesalers, to producers, etc., eventually getting back into the hands of consumers again. At each step part of the money is paid out as wages and salaries, that is as income, while part of it is passed on to a preceding stage of production in the purchase of the goods sold.

The length of time necessary for money to complete this circuit, from consumer back to consumer again, is called the circular or income velocity of money. It refers to the number of times during a given period a unit of money (on the average) is received as income by an ultimate recipient of income.

When new money is created, whether by government or by banks (or when hoarded money becomes active), and is spent and respent it increases the income of some one. As it makes the above circuit from consumer to producer and back to consumer, part of it is drawn off on the way and held idle (leakage, as this money is sometimes called) but the new money, nevertheless, ordinarily increases incomes several times its original amount. The number of times new money increases incomes has an important bearing upon economic conditions and policies such as "pump-priming." The above tendency is known as the multiplier principle.

Regardless of what are causes and what are effects in the theory of money, and in what items in the equation of exchange causes commonly originate, one fact is clear—if an in-

crease in the monetary supply takes place it is almost certain to have an effect eventually upon prices, unless the increase accompanies a greater volume of business or a greater demand for cash and is compensated for by this increase in the demand for money. If the increase in money is thus accompanied by more business or a slowing down in the rate of turnover, its effect may be counteracted.

In a country such as the United States, by far the largest part of the monetary supply consists of bank deposits. Bank deposits constitute some 85% of the total monetary stock. The total amount of money and bank deposits changes constantly and in the United States the amount may vary by several billion dollars in the course of a year. The sources of increases in deposits are four: (1) gold imported into the country; (2) new loans extended by banks to their customers; (3) additional investments made by banks; and (4) deposits of currency formerly in the hands of the public. A decrease in deposits is caused by the reverse of these operations, namely, (1) gold exported, (2) loans being paid off, (3) investments held by banks being sold, or (4) deposits being withdrawn in currency.

When gold is imported into gold standard countries, it goes into banks and adds to the deposit account of the one who brought the gold. When a bank loans money to an individual it usually increases the size of his deposit account in return for his promise to pay, or in other words grants him the right to draw checks upon the bank for the amount "loaned." This procedure involves a net increase in the country's bank deposits. A bank seldom lends physical money but lends its credit, which circulates by check and which can be turned into currency if desired. The bank must therefore keep a certain amount of cash against its deposits. Long experience has shown that on any one day only a few deposits are drawn out in actual cash, so that the bank can loan much more "money" than it actually has in cash. In this way a dollar of cash in reserve can support several dollars in deposit credit.

Although deposits are not backed 100% by cash they must, of course, be backed in full by something of value, whether it be promissory notes of borrowers, securities, or some other

asset. A new loan of \$1,000, for example, would add to the assets of the bank, because the bank would now hold the customer's promissory note for this amount. On the liability side of the bank's balance sheet would be, correspondingly, an increase of \$1,000 in deposits.<sup>8</sup>

When a bank buys government bonds or makes other investments, the transaction is not unlike making a loan to an individual. The bank receives the securities and in exchange gives a deposit credit, which involves an increase in total deposits. Buying a government or other type of bond is not very different from buying a promissory note; both are promises to pay.

Banks like to loan out as much credit as their cash reserves will permit, since the loans earn interest for the bank. For example, if a bank has \$100,000 in idle cash it might estimate that it could make loans for more than this amount on the basis of the cash. If the bank were the only bank in the town, the new deposits created would probably circulate by check from one depositor to another and little money would leave the bank. In practice, however, the bank would have to be prepared to pay out the full amount of the new loan in cash to some other bank. On the average, however, the full amount would not be paid out. When all banks gradually expand their loans together, the claims against each other tend to cancel, so that the banks are not called upon to pay out much cash because of the new loans. In this way a small amount of cash reserve can be used as a foundation on which can be built a large amount of credit.

**Credit, Prices, and Central Banking—the Federal Reserve System.**—Some countries have legal regulations regarding the

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<sup>8</sup> It has been proposed that banks be required to keep a 100% reserve in cash behind deposits so as to permit a better control by the government over the total volume of deposits. Cf. Irving Fisher, *100% Money*, New York, Adelphi Co., 1935; also Frank D. Graham, "Reserve Money and the 100% Proposal," *American Economic Review*, September, 1936. Various other proposals have been made regarding methods of keeping the volume of money and deposits in harmony with the demand for money so as to maintain a reasonably stable value for money, and so as to prevent or reduce the serious effects upon business and the entire economic system of a decrease in the supply of money relative to the demand. Such a decrease in supply reduces incomes and is an important factor in depressions.

amount of cash reserves which banks must keep against their deposits. In the United States these reserves are not kept in cash at each bank, but are largely in the form of deposits made by the banks at the Federal Reserve Banks (in the case of banks belonging to the system), and can be withdrawn from the Federal Reserve Banks upon demand. Most countries have a central bank, like the Bank of England or the Federal Reserve System, of a semi-governmental nature where other banks deposit their cash reserves, and where such banks may borrow if they need more funds. The central bank, by loaning to other banks, supplies the country with whatever credit it needs; it can supply credit to almost an unlimited extent.

Against reserves deposited at the Federal Reserve Banks, the Reserve Banks must keep cash reserves of their own to the extent of at least 35% of such deposits. The reserves of the Federal Reserve Banks consist almost entirely of certificates representing gold, the actual gold being held by the Treasury Department of the government. The Reserve Banks at the same time have other assets behind their deposit liabilities, as do the member banks.<sup>9</sup> As the member banks need cash they draw upon their reserve deposits at the Federal Reserve Banks, or, if these deposits are inadequate, borrow from the Reserve Banks. The Reserve Banks then pay out their own notes as the member banks want them. These notes—merely promises to pay of the Reserve Banks—are cash to the public and to the member banks.

Federal Reserve notes are thus paid out by the Reserve Banks to their depositors, which are banks, as the notes are desired. They can be issued in almost unlimited amounts, subject of course, to certain regulations. They are secured by all the assets of the Reserve Banks and are also guaranteed by the United States Government. If banks want more cash they draw upon their reserve deposits, or, if these are inadequate, borrow from the Reserve Banks taking the proceeds of the loan in notes or leaving the money on deposit. When the member banks

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<sup>9</sup> Federal Reserve assets other than gold certificates consist principally of government securities and of a certain amount (now very small) of high grade commercial paper which they have bought, or rediscounted, from the member banks.



borrow, they must pledge commercial paper which meets special requirements, government securities, or under certain circumstances other collateral.

A deposit at the Reserve Bank, it will be noted, may be regarded by banks as cash, and be used by them as the basis for granting new loans to their customers. The larger the reserve deposits, therefore, the more credit that can be extended by the banks and, to the extent that banks extend credit against them, the larger the volume of total deposits in the country. Commercial paper or other assets eligible for sale or rediscount at the Reserve Banks are as good as cash to a bank, since, if desired, they may be turned over to the Reserve Banks and converted into deposits there or into Federal Reserve notes. This has caused banks to be much less concerned about their own liquidity.

The Federal Reserve System, like other central banks, possesses broad powers to influence the volume of the country's bank deposits, although the situation in this respect has changed considerably in recent years. If the Federal Reserve Banks raised the rate of discount which they charged member banks, this tended to discourage borrowing by member banks, and was taken as a warning that the Reserve System believed that credit should be expanded less rapidly. This was a powerful weapon, provided the banks were borrowing at the Reserve Banks. It tended to raise interest rates and tighten credit throughout the country. This in turn tended to hold down or reduce the total amount of deposits. In recent years, however, the banks have not needed to borrow much so that this method of control has become of little use.

Conversely, a lowering of discount rates by the Federal Reserve System ordinarily tended to relax credit throughout the country, to encourage bank lending, and thereby to increase the size of the country's total deposits. Thus, raising or lowering the discount rates charged by the Reserve System enabled the System to influence the amount of borrowing or lending. This method of control has been used by European central banks for many years. When the commercial banks, however, do not

need to borrow, it is not very effective and at any event needs to be supplemented by other devices.

The Reserve System may also influence credit conditions by the purchase or sale of securities. These operations are commonly known as open market operations. If the Reserve Banks go into the open market and buy government bonds or other securities, the effect is to place Federal Reserve bank credit (i.e., deposits at the Reserve Banks) in the hands of member banks. The Reserve Bank pays for the bonds with a check on itself which, when it falls into the hands of a member bank, increases such bank's reserve balance. If it is received by a non-member bank, such bank then has more cash. In other words, such purchases increase the reserve deposits or cash resources of banks. The Reserve Banks are, in effect, receiving government bonds and giving in exchange deposits at the Reserve Banks, which can be used as the basis for credit expansion by the commercial banks. The result is a general easing of the money market and a tendency toward more liberal extensions of credit with consequent increases in the volume of deposits.

If the Reserve Banks, on the other hand, desire to contract credit, the process is reversed, namely, securities, largely government obligations, are sold from the assets of the Reserve Banks. This procedure reduces the reserve balances of member banks or cash resources of non-member banks. When the Reserve Banks sell their government bonds the proceeds received are withdrawn from the market. Checks received for the bonds are in effect charged against member bank balances. The effect is to tighten interest rates and credit conditions in general. As a result there is a tendency toward a contraction of the volume of bank deposits throughout the nation.

The Banking Act of 1935 gave the Federal Reserve Board authority to increase or decrease, within limits, the amount of cash reserves required to be maintained by member banks. This was first used in the summer of 1936 when reserve requirements were raised 50%. In 1937 they were raised the remaining 50% allowed by the law. The effect was to reduce considerably the excess reserves of the member banks, which had

constituted a sizable base for potential credit expansion. In April, 1938, reserve requirements were partially lowered in order to help revive depressed business, but were raised again at the end of October, 1941, to help check the inflationary expansion stimulated by the defense program. In August and again in September 1942 they were lowered slightly for central reserve city banks (i.e., in New York and Chicago) to facilitate the purchase of government bonds by these banks.

Such devices as raising or lowering reserve requirements and other methods of central bank control, powerful as they are under certain conditions, may at times be inadequate to deal effectively with prevailing situations. As a result of war-time expenditures by the United States Government, the volume of means of payment expanded rapidly and prices rose beginning early in 1941. Had the Federal Reserve Banks raised discount rates to check lending, this would have had little effect since the member banks had more than ample cash reserves and were not borrowing from the Federal Reserve. Raising reserve requirements in October, 1941 mopped up some of the excess reserves, but the banks still held sizable excess reserves. The sale by the Reserve Banks of their holdings of government securities would have drawn in additional amounts of the free reserves, but would have left the banks still with ample cash and would have had disturbing effects upon the government bond market.

While the Federal Reserve System is in a position to make an almost unlimited amount of money available to the country, it cannot, conversely, under war conditions use its restrictive powers to prevent an inflationary boom without hampering government financing of the war. The wartime price rise would have proceeded much more rapidly in view of the extent of the inflation, were it not for the government's program of direct price regulation—a procedure which works much better in time of war than in time of peace.

The expansion of the activities of the Treasury Department in the field of monetary and exchange regulation has brought dual authority in the United States in the field of monetary management. The profound effects of monetary movements

upon business conditions, upon production, employment, and economic progress generally make the monetary problem of outstanding importance. It has received increasing attention, both from economists and government administrators, but is far from solved.

## CHAPTER 13

### THE EQUILIBRATING PROCESS

We have noted that the trade of each country with the rest of the world combined must necessarily balance, in the sense that goods and services exported (including all invisible exports) must equal goods and services imported (including all invisible imports). In the conduct of foreign trade, the individual traders are not concerned with the manner in which their particular transactions affect the total payments or receipts of the country and contribute to or tend to upset the balance. An order is placed for goods abroad which increases the imports of the country, and necessitates an offsetting item which in some manner must pay for these imports. Under a free economy the process of balancing exports and imports, payments and receipts, tends to work itself out automatically, although the adjustments are sometimes economically painful.

The conduct of trade by governmental agencies, especially in conjunction with clearing and other agreements, sometimes includes attention to the effect of transactions upon the country's total balance of payments. Such attention has had to do especially with a balancing of trade bilaterally, i.e., between pairs of countries, as discussed in Chapter 30. The results of this are almost invariably a reduction of total trade and channeling of trade into lines not desired by consumers. Balancing of most of the world's trade, however, takes place through automatic adjustments; there is no deliberate effort to achieve a balance.

At the beginning of Chapter 8 it was said that one of the tasks of international trade theory was to explain these forces which tend to bring equilibrium in a nation's foreign transactions, to explain what is sometimes referred to as the mechanism of international economic adjustment. This mechanism functions largely through movements of prices, incomes, and exchange rates.

**Equilibrating Adjustments under the Gold Standard.—**

Under the gold standard these movements were intimately related to the flow of gold and to the policies of central banks. A lack of balance between exports and imports, between payment and receipt items, tended to cause exchange rates to rise or fall, depending upon whether there was an excess of exports or of imports. An excess of exports and other receipt items tended to result in a large supply of foreign bills and to cause, therefore, a fall in the rates for foreign currencies, while an excess of imports and a shortage of bills tended, conversely, to cause a rise in rates. The fluctuations were limited by the gold points so that the immediate and direct effects upon trade of such fluctuations were small. The indirect effects, however, working themselves out largely through gold movements, were not small. When rates are permitted to fluctuate widely in response to the demand and supply of bills, without limitation by gold points or exchange control, prompt and sharp effects follow.

Under the gold standard, when exchange rates went to the gold export or import point, the resulting flow of gold set up certain forces which automatically tended to restore exchange rates toward their gold par so that gold no longer moved. These forces also tended to bring a balance between exports and imports, and equality between the demand and supply of bills at a price close to par.

For example, if a country lost gold (perhaps because of insufficient exports and a consequent scarcity of foreign bills, and because, therefore, exchange rates had risen to the point where the exportation of gold was the cheapest method of acquiring foreign balances), the outflow of gold tended to contract bank reserves. This in turn tended to result in higher interest rates, tighter credit conditions, and a contraction in deposits. If the deflationary process were long continued it tended to reduce the level of commodity prices and incomes. Because of lower prices, foreigners would then find such a country a better one in which to buy, while not so good a country in which to sell. As exports from that country increased, the supply there of foreign bills would correspondingly increase; while as imports decreased, the demand for bills would

become less. The effect of the increase in the supply of bills and the smaller demand would be to reduce exchange rates and thereby check the outflow of gold and the deflation. Exports and imports would tend to come together and reach a balance.

Foreign countries which received the gold would tend to have higher price levels and incomes, and more active business, which would encourage further commodity exports to such countries, but discourage imports from them. Higher prices abroad and lower prices domestically meant that the foreign market was a poorer place in which to buy, but a good place in which to sell, so that the demand for bills tended to be less, but the supply of bills greater. The effect was to reduce exchange rates and check gold exports, that is, foreign currencies could be acquired more cheaply by buying bills in the market than by exporting gold.

The tendency of domestic interest rates to rise, accompanying gold exports, attracts foreign liquid capital, since capital is always seeking the market where the highest interest rates prevail, provided other things are equal. During recent years because of political and economic uncertainties, the risk element involved in loans in the different countries, together with restrictions on the free flow of funds, have interfered with capital movements and investment. These conditions have been important factors in the determination of the interest rates in the different countries. Interest rates thus may be high but because of risks involved, or restrictions imposed, foreign capital is not attracted. Nonetheless, gold movements, when they were taking place under the former system, tended to influence interest rates and thereby attract or repel foreign funds.<sup>1</sup>

These various forces and adjustments centering around gold

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<sup>1</sup> When conditions in a country that is disturbed, as France after the first World War, become more settled, confidence is reestablished and funds, including gold, formerly exported for safety tend to return. They return partly because of the higher interest rates domestically which prevail following the exodus of capital. The return flow of capital requires the offering there of bills on other countries in exchange for domestic currency of the country to which capital is returning. This increases the supply of foreign bills there and accordingly reduces exchange rates, tending to check the former outflow of gold. The foreign financial center that had been receiving the gold at the same time tends to have lower interest rates and easy credit conditions as a result of the new gold. This in turn encourages the exodus of capital and tends, once confidence has returned, to shift the tide toward the country losing gold.

movements are known as the price specie-flow mechanism. They tended to bring equilibrium between total exports and imports (the demand and supply of drafts). They tended to bring this balance by changing the amounts of goods and services given or received, so that the two would be equal (at the former values), and also by changing the terms of trade through price and exchange rate movements, thereby establishing new value ratios. These forces were constantly pulling back and forth, frequently overshooting the mark and causing fluctuations in exchange rates. In general, however, they tended to stabilize rates. They were like scales swinging back and forth toward balance, but perhaps never attaining it except momentarily. After the general abandonment of the gold standard, the gold points, of course, had no significance.

Although gold movements in or out of a country appeared to be induced by exchange rates going to the gold import or gold export point, the real reasons for the gold movements were more fundamental. They determined why exchange rates went to the gold export or import point. Under the former system if a country imported more goods than it exported, received more services from foreigners than it rendered, or for some other reason owed more money to foreign countries than was currently owing to it, that country would be short of foreign currency and rates would rise. It would tend to pay for the excess of imports by the exportation of some of its gold, as noted above. In the reverse situation, that is, if a country exported heavily to foreign countries, rendered services to them, or for various reasons was owed more money currently than it owed, it would tend to receive gold from abroad. In other words, gold tended to settle the differences between the current debits and credits in the international balance sheet and, by causing certain changes, to bring a balance between the payments and receipts. Gold provided the means by which the nation which was the net creditor got paid.<sup>2</sup>

It is not correct to regard gold under this system as having been the sole balancing item in the international balance sheet,

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<sup>2</sup> Funds deposited in London and New York were also used to settle balances, and obviated many gold shipments.



since, as already noted, gold shipments set in motion forces which brought about the needed adjustments. Thus, if a country exported heavily and tended to have an excess of credit, or receipt items, the supply of foreign bills became plentiful, and the bills became cheaper. This cheapness of bills tended to stimulate the purchasing of foreign goods, i.e., imports, and thereby provide a demand for the large supply of foreign bills. It also tended to increase tourist expenditures abroad. These and other influences tended to bring a balance between the total payment and receipt items, between the debits and credits.

Gold, when available, was a liquid item, sensitive to the dearth or cheapness of bills as reflected in exchange rates. It, therefore, was exported or imported if exchange rates moved very widely in response to demand or supply changes, and ordinarily flowed in the direction needed to bring a balance in current transactions. By leaving a country it created an additional supply of bills, since bills could be drawn against its export. By coming into a country it helped to absorb surplus bills offered, and which had caused foreign currencies to be cheap, the bills being needed to purchase the gold abroad.

Under the free gold standard the machinery by which gold was enticed into a country that was a net creditor on current transactions, or expelled from a country that was a net debtor, had to do immediately with exchange rate fluctuations and the gold points. More fundamental, however, were such things as movements in price level relationships which influenced the flow of goods between the countries, technological changes, shifts in demand and interest rates, and changes of other kinds which affected the demand and supply of bills.

It will be noted, therefore, that if the demand and supply of bills under the gold standard did not equal each other at a price within the limits set by the gold points, gold moved and tended to bring a balance. If a country was in the position of a current debtor, that is, had bought heavily abroad or had payments to make, for whatever cause, its citizens exerted a strong demand for drafts on foreign money centers in order to pay for their purchases. This demand for foreign money pushed the price of drafts up until it became cheaper to export gold to these

foreign centers and make payment that way than to pay the price demanded for drafts payable in the foreign currency. An export of gold, a credit or receipt item, thus tended to restore a balance between international debits and credits, and at the same time to stabilize exchange rates.

The reverse of the above situation was that a country that exported heavily, rendered services, or for other reasons was a current creditor, tended to receive gold because foreigners exerted a strong demand in their country for drafts on the creditor country. They wanted the drafts to pay for goods they had bought, and the strong demand pushed the price, or exchange rates, up to a point where it was cheaper to ship gold. The gold thus tended to flow to the country which was a creditor on current account. The effect of these gold movements upon the commodity price levels, incomes, currency systems, and banking conditions in the countries was, until the last two or three decades, profound. At times gold movements had little effect, but if the movement was of much size or continued long the consequences and ramifications were great.

These forces became less effective accompanying the many political and other difficulties after the first World War, and as the nations installed systems of control and restrictions upon the purchase and sale of drafts and upon the flow of commodities. Furthermore, central bank policies were increasingly dictated by domestic conditions, as noted below, rather than by whether gold was coming in or going out, and frequently endeavored to nullify the effects of gold movements, making credit easy to offset the tightness caused by gold exports, or tightening credit or sterilizing gold to counteract gold imports. Treasury operations also tended to overshadow the effects of gold movements.

**Gold and Central Bank Policy.**—The principal guide for central banks in their credit policies (i.e., as to the expansion or contraction of money) was historically the state of the gold reserve. When the reserve was large central banks allowed credit to become easy, while if the reserve were reduced the banks tightened the market, principally by raising interest rates.

After the first World War, central banks gave less attention than previously to gold in formulating their policies, but were guided by economic and other conditions.

Under the currency and banking systems prevailing in the leading countries until about 1931 or 1932 (although largely suspended during the period from 1914 to about 1925), if the gold standard was to be maintained, central banks had to be prepared to pay out gold as demanded. This meant that if gold reserves (or gold exchange) became dangerously reduced, or deposits "based" upon them became dangerously large from the standpoint of the maintenance of redemption, the bank would have to take some action to remedy matters. Although the United States had ample gold reserves, the Federal Reserve Banks could protect their gold if necessary by raising the rates of interest, or discount, which they charged member banks, and by selling securities in the open market, exchanging them for money which the Federal Reserve Banks withdrew from the market, as discussed in the previous chapter. This tended to tighten credit, to discourage borrowing, and thereby to reduce the volume of deposits.

If the gold reserve of a country had become so low that gold redemption had to be suspended, foreign exchange rates would then tend to depart from the limits set by the gold points, since gold would no longer be available for export at fixed rates. The system of exchange control, later to come into wide vogue, had not yet been developed, so that abandonment of gold (or gold exchange) payments meant foreign exchange depreciation. Thus it was that gold reserves were jealously guarded and at times tended to control or limit central bank policies.

The condition of the gold reserve, however, is not a satisfactory criterion for a nation's credit policy. The credit policy of a central bank has profound effects upon economic and financial conditions within a country, upon the state of business, investment, employment, speculation, and the general degree of prosperity; also upon trade and financial affairs in foreign countries. From the standpoint of international trade and finance, the monetary policy of any major nation is a matter of no slight importance to other nations.

The gold reserves of the United States have been so large that Federal Reserve policy has seldom been limited by gold. Interest rate changes, open market, and other control operations have thus not been dictated by the state of the gold reserve, although in 1931 and 1932 Federal Reserve policy was influenced by threats to its gold reserve. Especially since the bank holidays in March, 1933, and the subsequent dollar devaluation and heavy gold imports, has Federal Reserve policy not been limited by the gold reserve, but been determined largely according to the Federal Reserve Board's estimate of the general business, credit, and economic situation.

Whenever gold is imported into a gold-standard country it ordinarily goes into the banks (usually into the central bank), and the banking system is thereby provided with the means for credit expansion. Even in non-gold-standard countries the effects of gold imports may be similar if the gold is permitted to find its way into the monetary system. On the basis of the new money, banks can grant additional loans which mean additional deposits and additional spending. In this way gold coming into a country can, and frequently does, increase the amount of purchasing media by an amount much greater than the gold itself. An importation of gold consequently tends toward a higher level of commodity prices and incomes, lower interest rates, and increased business activity, unless counteracted by central bank policy. Conversely, if a country loses gold, as cash reserves diminish, the effect is a tendency for interest rates to rise, and for the banks to be less liberal in granting loans. Credit and the monetary supply accordingly tend to contract, and incomes and the price level to fall, unless central bank policy should be to liberalize credit and thereby offset the effects of gold exports.

If a gold-standard country is losing gold and the central bank in the face of it maintains an easy money policy, thereby preventing gold from remedying the situation which caused gold to flow, that country may lose a large amount of its metal and may be forced off the gold standard. This was the situation which prevailed in Great Britain prior to the breakdown of the gold standard there. Although the situation in Great Britain

was not simple, it was the opinion of many economists at that time that a policy of higher discount rates and tighter credit would have prevented leaving the gold basis. Whether such a policy would have been justified in the light of depressed domestic conditions is, of course, another matter.

It is clear that if maintenance of the gold standard and free foreign exchange parity necessitate depressed internal economic conditions, and are to be attained at the expense of a healthy domestic economy, the gold standard may either have to be abandoned or readjusted. In other words, gold movements and the state of the gold reserves are not proper guides as to the domestic monetary and fiscal policy which should be followed, except from the standpoint of maintaining the gold standard.

France in September, 1936, finally chose to reduce the gold value of the franc and abandon the former gold standard rather than to continue to have tight credit and depressed conditions within France. France had been losing large amounts of gold because her price level was too high in relation to those of other countries. After the United States devalued the dollar in January, 1934, the franc became worth approximately 6.6 cents in the foreign exchange market, determined by the new gold par between dollars and francs. The franc had previously been worth about 3.9 cents according to the old par. Although price levels in the United States and France had experienced drastic declines, prices in France did not decline enough more than those in the United States to make the franc worth as much as 6.6 cents in United States money. France, therefore, lost gold, since French goods were expensive abroad and not bought in sufficiently large amounts by foreigners to bring a balance in French payments and receipts. Instead of permitting prices to continue downward until the French price level was in harmony with those of other countries, on the basis of a 6.6-cent franc, France finally reduced the gold value of the franc and thereby brought exchange rates down to between 4 and 5 cents per franc and later to about 3 cents, making French goods cheaper abroad and in harmony with world prices.

The amount of gold reserve that a country needs if it is to maintain free redemption, domestic as well as foreign, that

is, the amount necessary to "support" a given volume of credit, is subject to wide variation, both from country to country and at different times within the same country. Banks at some times need larger reserves than at other times, depending upon business confidence, political conditions, the habits of the people, and other factors. While this relationship between credit and the gold reserve is not a rigid one, it is nevertheless a very real relationship—and at times may be an important factor in banking administration, if gold payments are to be maintained. The long drain of gold from France prior to devaluation in September, 1936, was a major factor in the discount policy of the Bank of France and finally forced the currency readjustment. If domestic redemption in gold is not allowed, as is now universally the case, the entire gold reserve is then available to meet foreign payments. The use of gold in international transactions is discussed in the next chapter.

In the past an increase in the supply of monetary gold sooner or later made itself felt in the level of prices by becoming the basis for new credit. The effect was either a rise in the price level, or the prevention of a fall in prices which would otherwise have come about because of growing business, new countries adopting the gold standard, or other demands for gold.

After the first World War, however, gold lost its dominant position and was a less and less influential factor in the determination of prices and economic conditions. By the time of the second World War gold had almost no influence upon prices and economic conditions, except as additions to the gold stock meant absolute increases in the monetary supply; however, the United States, the principal recipient of gold, already had large supplies of idle money. Even before the outbreak of war, domestic redemption in gold was nowhere permitted, and the availability of gold for export was rigidly restricted. Thus the price specie-flow forces had lost their practical significance.

The huge increase in monetary gold reserves, as a result of world-wide devaluations, peak production of new gold, and the disappearance of gold from circulation, raises the question as to what its future may be in the managed economies which have largely superseded the former system. The problem is of spe-

cial interest to the United States, which now holds the great bulk of the world's gold, and buys unlimited amounts of a metal, which like silver, would have little value were it not for American government purchases. Although its use as a domestic currency appears to be permanently gone, gold may still serve a purpose in helping to clear international balances and stabilize exchange rates, as noted in the next chapter.

**Adjustments under Flexible Exchange Rates.**—Countries that are not upon the gold standard and that do not have gold to export must settle their debit and credit differences in ways other than by the shipping or receiving of gold. Prior to the period of exchange control, suspension of gold payments meant that exchange rates fluctuated in response to the demand and supply of bills. The needed adjustments between debits and credits in the balance sheet were then brought about fairly promptly through an automatic raising or lowering of the values of the goods and services traded, and through changes in the amounts of the goods and services given or received. The results were similar to those under the gold standard, but the process was somewhat different and more abrupt, although followed by prolonged readjustments.

In both instances a balancing between the values of total exports and imports was accomplished by changes in the monetary values placed upon the goods traded, that is, in the terms of trade, and by such changes in amounts on either side as were necessary to make the trade equal. For example, if two boys are trading a top for a knife and if the knife is valued at \$2 and the top at only \$1, the boy receiving the knife still owes \$1. However, if the value of the knife is lowered to \$1, or the value of the top is raised to \$2, the trade is in balance. If the top and the knife are of equal value, but if the boy with the top receives two knives, he must then give another top or something else to make the trade balance.

When exchange rates are free to move, they bring about rapid changes in the values of goods by raising or lowering the cost of a country's currency and therefore of that country's goods in foreign countries. Thus, if Argentine pesos become

cheap in America, the cost of Argentine goods, when stated in terms of dollars, becomes cheap. A change in exchange rates in this way alters the value ratio at which goods are traded. For example, assume that the price of a pound sterling draft is cheap in America because of the large offering of pounds, and that the price levels within the two countries remain essentially unchanged. The United States then is able to buy British textiles more cheaply, that is, obtain more textiles for the same number of dollars. At the same time, in England, Britishers would find the cost of American raw cotton higher in terms of pounds, because American dollars would be more expensive. They would get less cotton for the same number of pounds. The British importer would have to provide the American cotton exporter with, we will say, £1,100 instead of £1,000 if the exporter is to receive the same number of dollars as formerly (or if the American is to be paid in dollars, the British importer would have to spend more pounds to buy the dollars). When some other American, the one who buys the pounds from the cotton exporter (and buys them cheaply), spends the pounds in England, he gets more textiles in terms of American dollars. Trade under this new situation amounts to the giving of less raw cotton for a larger amount of British textiles. The writing up of export or import values, or the writing down of values, in this way through exchange fluctuations, helps to bring about value equivalence to trade. It tends to establish equilibrium or balance in international payments. The process may at times involve drastic fluctuations in exchange rates in order to equilibrate the demand and supply of bills.

The cheapness or dearness in one country of the goods of a second country because of fluctuations in exchange rates obviously affects the amounts of these goods sold. This in turn affects the demand for bills with which to pay for the goods. Thus, if the price of pounds rises in New York, because of a scarcity of sterling bills there (insufficient exports or too large imports), Americans tend to buy fewer British goods, since the goods are accordingly more expensive. This reduction in buying of goods means also a reduction in the amount of sterling bills demanded. The original shortage in the supply of bills in



this manner tends to bring a reduction in the amount of bills demanded, and thereby to bring a balance between the international debits and credits, which represent trade and all other transactions. To help the process of adjustment, the higher price of sterling bills tends also to stimulate sales of American goods to Great Britain, and thereby bring export and import items to equivalence. This increase in sales to Great Britain creates an additional supply of sterling bills and tends to reduce the shortage. Other forces are also at work to help expand or contract exports or imports and thereby bring equilibrium.<sup>3</sup>

**Purchasing Power Parities.**—We have already noted that foreign exchange rates, if free, are determined immediately by the demand and supply of bills, and that under the former gold standard the fluctuations in rates were limited by the gold points and the possibility of shipping gold.

Persons who buy foreign bills ordinarily want them to purchase goods in the country on which the bills are drawn, or to make other payments there. The desirability of a foreign bill is thus greatly influenced by the prices prevailing in the foreign country, in other words, by the amount of commodities or services which can be bought with the currency represented by the bill. If prices in a country are low in the sense that the currency unit buys many commodities, that country's currency is obviously more desirable than if prices there were high. The demand for bills is, therefore, influenced by (and influences),

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<sup>3</sup> Even though the gold standard does not prevail, gold movements still help to settle differences between exports and imports, since gold moves as a commodity in response to price.

In a gold-producing country on the gold standard, gold could be exported regularly as a commodity at the same time that it was being exported as international money in connection with the balance of payments. Lack of balance in such a gold-producing country's balance of payments would result in either the slowing down or acceleration of the regular gold exportations, depending upon whether more or fewer foreign credits were needed to pay for the country's importations. If there were a deficit in the country's foreign accounts and additional credits (i.e., more foreign bills) were needed, the gold-producing country's bank reserves would probably be called upon to provide additional gold for export against which gold exports bills could be drawn. If there were a surplus in the country's foreign accounts so that more foreign credits (i.e., a plentiful supply of bills) were created than were needed to pay for the imports, some of the newly mined gold would then tend to go into the country's own bank reserves rather than be exported. By going into local banks, the gold would provide its owners with more local currency than could be realized by exporting the gold in view of the low price of foreign bills.

the prices in the foreign country, or the purchasing power of the currency unit.

The price level in the home country is, of course, also a factor. For example, if prices in America should rise so that the dollar would buy fewer commodities, while at the same time prices in France fell so that the franc would buy more commodities, a bill on France would be more desirable to an American than previously. The expression "purchasing power parity" is used to refer to this price level relationship, namely, to the parity between the two currencies on the basis of what each will buy in its own country. For example, if the pound would buy in England about five times as many commodities as the dollar would buy in America, the purchasing power parity of the pound would be \$5. If prices in the United States rose while those in Great Britain remained constant, the pound would be worth more than \$5 on the basis of its purchasing power. It might buy as many commodities as \$6 would buy in America. The purchasing power parity is, therefore, exactly what the wording implies—parity on the basis of purchasing power.

The question arises as to what relationship exists between the purchasing power parity and market exchange rates. If the purchasing power parity of the pound is \$5, what effect does this have upon prevailing exchange rates? Under "normal" conditions purchasing power parities and exchange rates tend to coincide. In recent years, however, exchange control and the many artificial restrictions imposed on foreign transactions have created a situation wherein purchasing power parities may diverge considerably from exchange rates. If the currency of a country is undervalued in the exchange market in the sense that its internal purchasing power is high, the country becomes a good one in which to buy. Increased purchases in that country by foreigners would create a demand for bills on it, which would tend to raise the exchange rates until they were in line with the internal value of the currency. The demand and supply of bills in this manner would tend to bring a rate of exchange fairly representative of the internal value of the currency. Where exchange rates are free to fluctuate, because of the absence of gold points, exchange control, and stabilization operations, such

adjustment usually takes place more quickly than where exchange rate fluctuations are limited.

Between countries having the gold standard, exchange rates were relatively stable. In such cases the adjustment between purchasing power parities and exchange rates had to come through movements in price levels, unless the par of exchange was altered through gold revaluation. In other words, purchasing power parities must do the adjusting if exchange rates are rigid. Automatic forces tended to bring this price level adjustment under the former gold standard, as discussed above. For example, if the price level in Great Britain were high, so that the pound was worth in buying power only \$4.50 instead of its previous gold par of \$4.86, and if the gold points were effective and kept rates approximately at par, persons in the United States would find British goods expensive in terms of dollars. This would be because the pound was no cheaper than formerly in terms of dollars, while prices in Great Britain were higher. The result would be a reduction in the demand for bills on Great Britain. The price of British bills in New York would fall to the gold import point, and Great Britain would lose gold to the United States. Prices would tend to fall in Great Britain and to rise in the United States until equilibrium was established between the purchasing power parity and market exchange rates.

The abandonment of the gold standard, adoption of the many control devices introduced during recent years, and the drastic economic and political changes, have interfered with the operation of these forces, and brought it about that price levels in the different countries are in many instances considerably out of line with exchange rates. The effect of this is usually to reduce the total volume of trade, since if the price of a foreign currency is held down below what it would otherwise be, i.e., below its free equilibrium rate, exports to such country are discouraged inasmuch as they yield the exporter less of his own currency. Imports from such a country, on the other hand, would be artificially stimulated by the cheap rate were it not for the fact that the purchase of bills on such country must be limited, due to the shortage of exchange. In other words, the rate does not equilibrate demand and supply.

**Limitations of Purchasing Power Parity Doctrine.**—The theory of purchasing power parity was revived during the first World War by Gustav Cassel of Sweden.<sup>4</sup> As originally presented by Cassel the theory was deficient in failing to allow for the fact that trade between two countries might shift due to a variety of reasons that had little or nothing to do with price movements, and that this shift in trade might alter the demand and supply of bills, and therefore the equilibrium rate of exchange. For example, a technological change might cause the goods of a certain country to be in large and strong demand, and on a more or less permanent basis. Exchange rates on such a country would tend to rise, assuming they were flexible, and might reach approximate equilibrium at a level considerably above the former rates. No change in price levels, however, need have taken place.

Another reason why the theory is not a complete explanation of exchange rates is that the price level of a country includes the prices of many articles of domestic or largely domestic consumption. These prices may change and cause a movement in the price level, or purchasing power of a currency, with slight, if any, effects upon foreign payments and receipts, and therefore upon exchange rates. In other words, exchange rates and price levels are both subject to independent influences which may increase or decrease the discrepancy between the exchange rates and price levels. Furthermore, it was assumed that the price levels in a base year were in agreement with exchange rates, that is, were in approximate equilibrium at the prevailing exchange rates, when they very well might not have been.

In view of these facts, an apparent lack of correspondence which may be discovered between price levels and exchange rates should be interpreted cautiously. Nevertheless, the greater the divergence between the internal purchasing power of a currency and the external purchasing power, or the price in foreign markets, the greater the incentive for foreigners to buy that currency and secure goods in the country where their money has a large purchasing power. This tends to draw exchange rates and price levels into harmony.

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<sup>4</sup> For further discussion of this doctrine see Chapter 18.

Under assumptions of perfectly stable and free conditions, the price level relationship of two currencies, that is the ratio between their purchasing powers (purchasing power parity), would be identical with the rate of exchange. An equilibrium rate of exchange, under the above assumptions, would include equilibrium between the purchasing powers of the two currencies. If there were a discrepancy between price levels in that money would buy, via exchange rates, more in one country than in the other, exporters and importers would become active and the advantage would tend to disappear. Equality in purchasing power at the equilibrium rate would thus have to prevail under these assumptions.

Under disturbed conditions—which is the usual state of affairs—free exchange rates fluctuate, sometimes widely, without corresponding changes in price levels. A new rate may bring temporary but unstable equilibrium without any compensating change in price levels. The equilibrium rate is merely the rate that equilibrates, and this rate may be anywhere depending upon demand and supply conditions at the moment. Every free rate is an equilibrium rate with respect to existing forces, but these forces may be of a transitory and unstable nature. They may include extraordinary capital movements or other special conditions which cause wide fluctuations in rates. If the rate departs far from the ratio of the internal purchasing powers of the currencies, the advantage of buying in the country of cheap prices exerts strong pressure to bring rates toward their purchasing power parity. Although it is difficult to compare the purchasing powers of two or more currencies, because of differences in the qualities of goods and because of other difficulties, nevertheless at some rate of exchange the price levels may be regarded as equal or at least in equilibrium.

The internal purchasing power is thus an influential factor in the determination of the equilibrium rate of exchange—both cause and effect as in all interaction. A movement in prices tends to alter the equilibrium rate; and conversely a movement in the rate (due perhaps to changes in reciprocal demand or other factors) tends to alter price levels.

During the period of currency inflation following the first

World War, when price rises were rapid and often extreme, the concept of purchasing power parities helped to direct attention to the close relationship, commonly overlooked by governments, between price movements and exchange rates, between internal depreciation and foreign exchange or external depreciation. The concept is also useful in helping to determine during disturbed periods the approximate equilibrium rate were prices to become more stable.

**Purchasing Power Parity of the Pound and Dollar.**—The accompanying chart (Figure 3) shows the purchasing power parity of the pound sterling and the American dollar from 1912 through 1941, and the relation of the purchasing power parities to market exchange rates. During the first World War period, from early 1916 to March, 1919, exchange rates were “pegged” at \$4.76 and fluctuations one way or the other were very slight. This artificial stabilization of exchange rates was accomplished through loan operations undertaken by J. P. Morgan & Co., agents in New York for Great Britain. During this period, however, the level of commodity prices in Great Britain rose considerably. It rose more than that in the United States, with the result that the pound was not worth its artificial price of \$4.76. For much of the time the pound was worth about \$4 in American money on the basis of its buying power in relation to that of the dollar. The chart shows this divergence.

When artificial control over exchange rates was discontinued in the spring of 1919, it will be noted, the rates fell very rapidly, and were soon in harmony with purchasing power parities. Furthermore, large importations of goods from the United States had caused the merchandise balance of trade to be heavily against Great Britain. This contributed to the decline in rates. Rates fell below the purchasing power parity level. From 1919 until the period of the depression beginning in 1929, the two curves moved in fairly close harmony, Great Britain returning to the gold standard in the spring of 1925.

From 1929 until about 1940 a discrepancy existed between exchange rates and purchasing power parities. This was a period of drastic price level changes and heavy movements of capital.

# POUND STERLING

EXCHANGE RATES AND PURCHASING POWER PARITIES

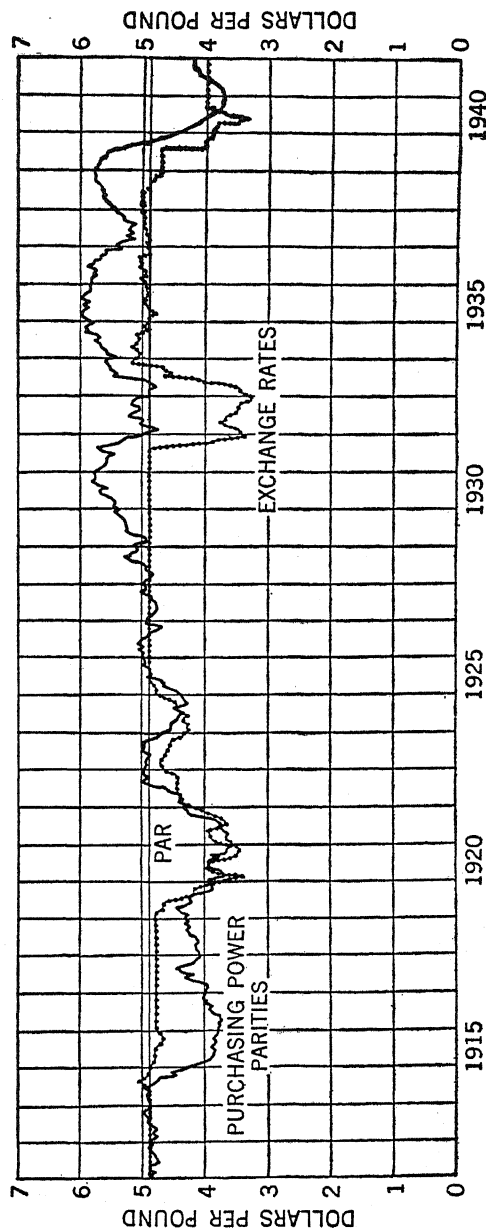


Figure 3. Exchange Rates and Purchasing Power Parities of Pound Sterling Since 1915

It was also a period when numerous artificial barriers to trade were erected and control devices instituted. The dollar was almost continuously in strong demand.

After war began in 1939 exchange rates depreciated sharply, until they were pegged at approximately \$4.02.<sup>5</sup> The purchasing power parity of the pound declined rapidly after war commenced and as prices in Great Britain rose. However, as prices in the United States rose, especially beginning early in 1941 and rising more rapidly than those in Great Britain, the purchasing power parity of the pound turned up. When price levels in both countries became relatively stabilized through control measures, purchasing power parities and exchange rates were close together.

COMPUTATION OF PURCHASING POWER PARITIES.—The method of calculating purchasing power parities mathematically is as follows: The first step is to measure the price levels of the two countries in terms of a common denominator. For this purpose index numbers with the same period as a base are used; but since the index numbers represent prices in different currency units, the numbers are reduced to a uniform basis by multiplying one by the par of exchange, or what is considered a representative rate, as it existed during the base year. (This assumes that purchasing power parities and exchange rates were in harmony at that time, which may or may not be a valid assumption.) Thus, if the index numbers for Great Britain and the United States are both 100 for the base year 1913, the index number for the United States for that year should be raised to 486, since the gold par between dollars and pounds is about \$4.86 to the pound, and the pound would presumably purchase this many times the amount of the dollar. If prices in both countries doubled the next year, index numbers would stand as 200 for Great Britain and 972 for the United States, and the pound would still purchase 4.86 times as much as the dollar. However, if prices in Great Britain doubled and prices in the United States went up only 50%, the index numbers would

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<sup>5</sup> Immediately after the outbreak of war the official rates established for dollars were \$4.04 buying rate, and \$4.02 selling rate. The free rates for pounds as quoted in foreign countries were much lower, until the latter part of 1940 when control measures were so tightened that the fixed rates of \$4.02½ and 4.03½ prevailed in almost all markets.



be 200 and 729, respectively, and the question would arise whether the market rate of exchange between dollars and pounds coincided with this ratio of the price levels.

The ratio between the price levels under the above assumption would be  $729/200$ , or 3.65, instead of the previous  $486/100$ , or 4.86, which was the gold par of exchange. The purchasing power parity of the pound with the dollar would thus be \$3.65. This represents the internal value of the pound compared to the internal value of the dollar, expressed in terms of dollars, so that it can be compared with the value of a pound in New York also expressed in dollars.<sup>6</sup> It is seen that the purchasing power parity between two currencies is obtained by multiplying the ratio between the two current index numbers of prices by the previous price parity of the two units, which is assumed to have been the same as the exchange rate in a "normal" year.

Another, and perhaps simpler, way to express the purchasing power parity of the pound is as follows: It was assumed that prices in the United States rose from 100 to 150, while those in Great Britain rose from 100 to 200; thus the purchasing power of the pound would be  $150/200$ , or 75% of its previous par of \$4.86, and therefore \$3.65. To compare divergencies between purchasing power parities and current exchange rates, the former may be expressed as percentages of exchange rates. Thus, if the actual exchange rate were \$4, the purchasing power parity expressed as a percentage would be  $365/400$ , or about 90% of the exchange rate.

The purchasing power parity between two currencies is thus obtained by multiplying the current index number of the country in whose currency the figure is to be expressed, by the par of exchange of the base year (or the rate of exchange that year if this can be regarded as fairly representing the price relationship), in order to make the two index numbers comparable, and dividing this result by the current index number of the second country.

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<sup>6</sup> Another way of stating the same thing is that on the above supposition that the pound had lost half its purchasing power, assuming for the moment that prices in the United States had not risen at all, the pound would have purchased, instead of 4.86 times as much as the dollar, only 2.43 times as much. But inasmuch as prices in the United States on the first assumption went up 50%, the pound ought to purchase 2.43 times as much as the dollar plus 50% of 2.43, or a total of 3.65 times as much as the dollar.

Thus:

$$\frac{\text{Index Number A} \times \text{Par of Exchange}}{\text{Index Number B}}$$

As between the United States and Great Britain this would be:

$$\frac{\text{United States Index} \times 4.86}{\text{British Index}}$$

Statistical studies of purchasing power parities and exchange rates should make allowance for the unsuitability of some of the available data, and also for theoretical considerations discussed above. For example, when a comparison is made between the price levels of two countries, most of the index numbers which are available for such a comparison are based upon different kinds of commodities, and include articles of home consumption which do not enter into foreign trade. The different methods of constructing index numbers, together with possibilities of error, make difficult accurate comparisons between the rate at which the currencies of two countries actually exchange and the ratio of the price levels of the two countries. If index numbers are constructed so as to include only similar goods and only those which enter into international trade, this overlooks certain indirect influences. Moreover, allowance should be made for such items as transportation charges, tariffs, and other barriers to free interchange of commodities, which prevent prices for the same things from being the same or from fluctuating in the same ratio. Furthermore, as already mentioned, it is assumed that the price levels in the base year were in agreement with exchange rates, when this perhaps was not the case; in fact, was probably not the case. The farther away the base year is, the less reliable are current computations.

## CHAPTER 14

### EXCHANGE STABILIZATION

**Independent Currency Systems.**—The world has nearly as many currency units and systems as it has countries. These currency systems, however, are not separate and distinct, but are intimately related to each other. The currency problem is an international one involving price relationships, monetary policies, exchange rates, the flow of gold, trade and financial transactions, capital movements, tariffs, regulatory activities of governments, and many other matters.

Trade and financial dealings cut across national boundaries and embrace the entire world. Yet the world has no international currency unit in terms of which trade and financial transactions can be conducted. Trade must select the unit of some particular country to serve this purpose, such as the British pound or the American dollar. Even though a currency serving international trade be reliable and stable internally, a difficulty exists in that foreign transactions require that funds be transferred from one currency into another currency. The importer must acquire the exporter's currency in order to make payment, or the exporter must convert the importer's currency into that of his own country. The machinery for transferring funds from one currency into another has been unable to withstand abnormal situations. It functioned smoothly only under relatively simple and balanced conditions. The world, however, is constantly facing crises and conditions of stress and strain.

Transactions between countries have for centuries been becoming increasingly larger, and financial affairs of the world more and more closely interwoven and interdependent. The existence of so many independent currency units and systems has handicapped this basic trend toward economic integration and expansion. A variety of currencies is a barrier to investment.

the development of resources, and to progress generally. More recently, exchange control and other interferences with the transfer of funds have emphasized the difficulties which result from independent currency systems.

When the rate of exchange between currency units fluctuates, for whatever reason, uncertainty is injected into all transactions, particularly into those that extend over a period of time. International borrowing and lending have no reliable unit in which the transactions can be stated, so that one of the parties must assume a risk. If the debtor agrees to repay in a currency other than his own, he does not know what this may cost him. On the other hand, if a creditor agrees to accept payment in the currency of the debtor, he does not know how much of his own currency this will yield him. Although in ordinary exporting and importing transactions, machinery exists for avoiding some of the risk of exchange, it is not always practical to avoid this risk. The existence of this risk adds to the expense of trading. One of the serious handicaps to international trade and financial dealings has thus been the uncertainty regarding exchange rates.

The fact that currency difficulties of a country cannot be isolated was exemplified by the departure of Great Britain from gold in 1931, following which the currencies of several other nations in various parts of the world immediately collapsed. Countries that maintained funds in London, often as part of their currency reserves, suffered losses and internal disturbances when the pound was divorced from gold. The collapse of the pound was itself brought on mainly by conditions outside Great Britain. Currency developments in the United States in 1933 and 1934 were greatly influenced by British abandonment of gold. Devaluation by France in September, 1936 became necessary largely because of events transpiring outside of France. French prices had become out of line with those in other countries, principally because of happenings abroad, so that France was compelled to readjust her currency. The currency problem is not a domestic matter but is international in its scope and nature. Recognition by governments that the currency problem is fundamentally an international one, and must be approached by joint endeavor, has increasingly taken place.

International financial transactions of unprecedented size which took place after the first World War emphasized the difficulties inherent in independent currency systems. Reparation payments, war debts, foreign loans, and investments all involved large transfers of capital. In addition, the disturbed conditions throughout the world, coupled with improved transportation and communication facilities, contributed to mass migrations of capital. Because of disturbed conditions, capital frequently fled from country to country, seeking safety. To provide for these capital transfers, profound adjustments in foreign trade were necessary—changes in exports, imports, and in the so-called invisible trade. These adjustments, difficult under any conditions, were impeded by tariffs, embargoes, quotas, exchange control, and other restrictions, as well as by the monetary policies pursued. It was not surprising that the gold standard broke down when increasing strains put it to the test in 1931 and the years following. The international exchange mechanism was called upon to provide for the transfer of large sums from one currency into another—a transfer that often took place, or endeavored to do so, suddenly, before the flow of merchandise or services could provide an adequate supply of the foreign currency.

A substantial body of securities exists for which ready buyers can be found in any large city of the world, and which can be easily shipped from country to country. Foreigners hold large amounts of American securities, and similarly Americans hold large amounts of their securities. A network of short-term credits, bank deposits, securities, and other liquid assets that may be readily moved from place to place links the foreign nations together. As a result, huge amounts of funds may suddenly present themselves for transfer from one country to another, that is, from one currency into another currency. A country such as the United States, which holds on deposit large amounts of funds owned by foreigners, has been constantly faced with the possibility of substantial withdrawals.

The violent changes in the demand or supply of a currency on the exchange market because of capital movements was often the cause of drastic fluctuations in rates, when exchange movements were permitted—that is, prior to the period of exchange

control instituted during the nineteen thirties. Gold and foreign exchange reserves were called upon to provide the ways and means for settling these capital transfers, and the strains put upon the international currency mechanism were more than it could bear. Capital movements drained off the currency reserves and caused suspension of specie payments, depreciation of the currency in the exchange market, or the adoption of exchange control and rationing. Political and other disturbances frequently caused liquid funds to run to cover, and led to the sudden depletion of a country's currency reserves.

It is not the flow of merchandise or services between countries that is subject to sudden and erratic fluctuations on a large scale. It is capital movements and speculative operations that lead to the rapid depletion of gold reserves and foreign exchange holdings. Changes in merchandise transactions come about gradually, except in wartime, but huge shifts of capital often develop with little warning.

**The Price of Gold and Exchange Rates.**—Under the gold standard, exchange fluctuations were confined to the very narrow limits set by the so-called gold points. Gold moved in and out of countries and tended to cause price level and other adjustments so that the total of export or receipt items of a country equaled its total import or payment items—at or near the par of exchange, which was determined by the gold contents of the different currency units. In other words, the demand and supply of bills was brought to equality at the established price or rate of exchange for the currency, rather than the price being increased to equalize demand and supply. Exchange rates were thus relatively stable regardless of changes in reciprocal demand, and trade was made to adjust itself so that export and import transactions would balance.

The meaning of the gold standard underwent a change after the first World War, and a country was said to be on the gold standard so long as its currency was in actual fact maintained on a parity with gold, regardless of whether there was redemption in gold or existence of a gold reserve, and regardless of the nature of the machinery by which parity was maintained. The

essence of the gold standard was parity with gold. With the exception of a few of the larger countries, namely the United States, Great Britain, and France, parity was maintained principally by the sale and purchase of foreign bills at what was regarded as the parity rate. To do this, central banks maintained sizable balances abroad.

The automatic forces of the former gold standard, the so-called price specie-flow mechanism, functioned imperfectly or not at all during this period, since currency policies were not determined according to the state of the gold or foreign exchange reserve. The full gold standard, therefore, did not exist, and was quite different from the arrangements of this period that emphasized parity with gold but did not include the price specie-flow mechanism. This change marked the beginning of the end of the classic gold standard.

The system that developed was sometimes called the gold exchange standard, but it differed from the gold exchange standard as previously understood and at one time in force in the Philippines, Nicaragua, etc., in that the gold exchange standard provided substitutes for the price specie-flow mechanism, that is, automatic increases or decreases in the volume of currency, just as though gold were imported or exported.

Under the gold standard, or under a gold parity system, the gold content or par of a currency unit (the price of gold in terms of the unit) determined the exchange rate between it and other currencies on the gold standard. When governments changed the price of gold, this meant altering exchange rates. Since internal redemption was no longer allowed by these countries, and since domestic currency and credit conditions were to a large extent divorced from gold and not greatly influenced by the amount of gold in the unit, changing the price of gold had little immediate effect upon the level of prices of domestic commodities, but did affect exchange rates and was followed by important consequences.<sup>1</sup> Historically, of course, the amount of gold in a cur-

<sup>1</sup> The prices of commodities entering into international trade are, of course, promptly affected by a change in exchange rates. Inasmuch as international commodities constitute an important part of the total of all commodities, and since their prices enter into domestic costs and are part of the general price structure, changes in the prices of international commodities are communicated to other prices altering domestic prices and price relationships.

rency was a major factor in determining its value, but after 1914 gold played a less important rôle in determining the value of money.

Gold has been tending toward the status of other commodities, so that the price of gold by the time of the second World War was significant principally in its effect upon: first, the relationship between the different currency units and systems that maintained a gold standard, i.e., gold par; second, the mining of new gold (a high price stimulating additional production); third, the expense to governments (principally the United States) in acquiring this gold; and fourth, upon efforts of various kinds to prevent the gold from entering monetary channels and interfering with monetary policy.

Since the beginning of the second World War gold has lost most of its little remaining significance as money, and is merely a commodity bought by the United States at a fixed price, a high price. Were it not for the United States' willingness to give \$35 for every ounce, the value of gold would doubtless be much lower.

When the United States raised the price of gold in 1933 and 1934, an immediate effect was to attract gold to this country where many more dollars could be obtained for each ounce. As exchange rates and other currencies became adjusted to the new price of gold, the stimulus to gold importations became less. Although the United States received huge quantities of gold following the devaluation of the dollar, much of this represented capital flowing to America for safety due to disturbed conditions abroad, rather than to the high price for gold.

Lowering the price of gold would discourage new and unnecessary gold production but would necessitate writing down the value of existing gold held. Some of the gold was previously written up, but the loss in writing down the huge stock of gold now owned by the United States would be very great. The loss of writing down this gold is from the economic and social standpoint only a bookkeeping transaction, and not a loss of real wealth. Altering the number of dollars that attach to an ounce of gold would not change the amount of existing gold any more than would changing the number of inches in a foot affect the



area of a piece of land. The value of gold in terms of commodities—the number of commodities that can be bought with the gold—is more important from the standpoint of real loss or gain than the number of dollars into which an ounce is divided.

Most of this gold was acquired from foreigners who received \$35 for every ounce, but to get them to take it back for an equivalent amount of purchasing power is not easy.<sup>2</sup> Much of the world has lost interest in the gold standard, at least the former type of gold standard, so that the value of gold and its position in future currency systems are uncertain. Gold is an imperfect stabilizer of prices, economic conditions, and demand generally, so that if it is used in currency systems it will no doubt play a subordinate rôle. It can be useful, however, in helping to stabilize exchange rates.

**Monetary Policy.**—For several years most of the world's currencies have been subjected to an increasing amount of control and management. The policies, however, are to a large extent not correlated, but are pursued each independently of the other. Modern currencies are all managed to a greater or less degree so that the term managed currency is a relative one; no currency can be said to be entirely unmanaged. The phrase thus refers to a currency receiving a large degree of management for the purpose of controlling or directing its value toward a desired goal—usually that of stable value and stable economic conditions in general. The managed currency question is principally one of currency techniques and of how far it is wise and possible to proceed with management, or of how far it is possible to improve upon gold and automatic forces.

The major nations have for some time been experimenting with managed currencies. Governments are no longer being guided primarily by the state of the gold or foreign exchange reserve, but are endeavoring to administer their credit and currency systems the way they desire, especially from the standpoint of exchange, price, and economic equilibrium—although too often policies are determined according to the exigencies of the treasury, or with little understanding of currency principles.

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<sup>2</sup> A large portion of the dollar assets created by the gold inflow is still owned by foreigners and remains unspent in terms of goods and services.

The currency policies pursued by the different nations have profound effects not only upon the countries themselves but upon economic conditions in other countries. The currency policy of the United States is a determining factor and of major concern to the entire world, particularly in view of the close relation between currency policy, the rate of investment, and economic stability and progress.

Various proposals have been made regarding procedures aimed to attain price and economic stability, such as the 100% money plan advocated by Irving Fisher, which would require banks to maintain a cash reserve of 100% behind deposits so as to permit more control by the government over the volume of deposits. Another proposal is the commodity reserve plan of Benjamin Graham wherein the price of a representative group of storable commodities would be pegged, and a fixed amount of money paid out freely for given quantities of the composite group; or conversely, the group of commodities would be given in exchange for the fixed amount of money. While the price of no single commodity would be fixed, the price of the group as a whole, consisting of given quantities of individual commodities, would be fixed or stabilized so that the group of commodities could, in effect, be monetized freely, or conversely, the group could be redeemed at any time in money. The aim of this plan is a semi-automatic currency, with a minimum of management, which would result in a relatively stable value of the unit, and prevent a drastic decline in demand.

The trend currency affairs are taking has been developing for a long period of time. Monetary systems have not functioned well when left entirely to automatic devices, so that control through the central bank and other agencies long ago was recognized as necessary. Such control over currency, credit, and gold movements has been exercised increasingly for several generations. At the time of the Bank Charter Act of 1844 discussions in England were active as to the best method to regulate the currency, and as to policies to be pursued by the central bank. Because of shortcomings of the gold standard, the world has in recent years been actively exploring new ground; it has made costly mistakes, a not unusual accompaniment of progress.

Currency developments during recent times have gone through three clearly defined stages. During the first stage, which ended in the summer of 1914, gold was the main determinant of currency and credit policies of the major nations. Efforts were directed by the monetary authorities toward maintaining free gold payments, and setting the stage so that the gold standard could function, so that the price specie-flow mechanism could operate. Gold circulated from hand to hand and was freely exported and imported. Great Britain was the historic bulwark of the gold standard, and the pound sterling was continuously redeemable in gold from 1821 to 1914.

During the second or transitional period, which began after the first World War, the aim was still to permit free gold payments—usually only in large amounts—or to redeem in the “equivalent” of gold, but to manage gold rather than be managed by gold. Internal economic and political conditions were the criterion of credit policy, rather than the state of the gold reserve, or of the foreign exchange reserve which was regarded as practically the same as gold. The attempt was made to reconcile the maintenance of free gold payments with monetary policies that were divorced from price specie-flow forces—an attempt that was doomed to eventual failure. Countries were trying to compromise between the gold standard, which they were reluctant to give up, and managed currencies. It was a period of stress and strain when any type of currency system would have encountered difficulties.

The third period began with the definite abandonment of gold by Great Britain in September, 1931 and has been characterized by the virtual elimination of gold from currency systems and of any efforts to maintain gold payments. The war furthered this trend away from gold. Currencies were cut loose from gold during the nineteen thirties without previously prepared plans or carefully thought out machinery for regulation, in fact, too often without any clear understanding of currency principles. Governments were forced to deal with currency problems that could not be postponed, and accordingly groped blindly or adopted opportunistic policies. The general chaos in the world included the field of currency.

What the post-war period will produce in the way of regulated currency systems, and the extent to which these may or may not utilize gold, remains to be seen. A large supply of gold exists, mostly concentrated in the United States, and the question presents itself as to what is the most useful purpose that can be served by this hoard of metal. As discussed below, gold can advantageously be used in settling international balances and stabilizing exchange rates.

Whatever procedure or machinery is set up, the objective of any currency system must be the attainment of an adjustment of currency supply to currency demand which will promote continued maximum production, employment, and utilization of resources. Relative price stability would probably be an accompaniment, but in itself is not the main objective. The extent to which monetary policy can contribute to full production and economic stability, or prevent instability, is still in dispute. While it is generally agreed that monetary policy is not a "cure-all," it is, nevertheless, recognized as a matter of major consequence.

**Rigid versus Flexible Exchange Rates.**—When gold served as a common denominator or link between the different currency systems, the gold standard provided automatic exchange stability within the gold points. The currency systems developed in recent years, however, have had no fixed relationship to each other, except such as may be established for temporary or indefinite periods. Exchange fluctuations are the source of certain obvious difficulties, so that nations are confronted with the question of what they can do and how far they should proceed in the direction of fixed or rigid exchange rates. If the extreme exchange fluctuations are largely eliminated through stabilization operations, there is still the question of what to do about the more gradual movements or trends, whether they should be allowed or whether fixed rates should be maintained.

Efforts to maintain fixed rates necessitate forcing trade and other transactions into a position where they balance at the established rates. This may require harmful internal price and other adjustments; if these adjustments are not made total trade

tends to shrink. Measures to protect fixed rates may be inconsistent with policies best suited to domestic conditions, so that a country may be compelled to decide between the maintenance of fixed rates and the pursuit of policies indicated by domestic economic conditions, and conducive to prosperity and full employment. It is held that fixed rates put the emphasis in the wrong place, which was one of the difficulties of the gold standard, and that domestic conditions should not be sacrificed to the maintenance of fixed rates.

Exchange rates that are fixed, or that are allowed to fluctuate only within narrow limits, have the important advantage of bringing more certainty into foreign trade transactions, particularly transactions spread over a period of time such as international borrowing and lending. Stable exchange rates facilitate exporting and importing, and the investment of capital; they contribute to confidence, which is conducive to a healthy trade. Their maintenance, however, has at times undoubtedly been costly in terms of domestic well being, bringing deflation, falling commodity prices, unemployment, and other evils.

Exchange rates express a definite value relationship between two currencies, yet this particular relationship may not be representative of the real values of the currencies in their respective countries, i.e., their purchasing powers. If rigid rates are to be maintained, adjustments of the internal economies are, therefore, continually necessary so as to keep internal values in harmony with external values, and to bring equilibrium at the fixed rates. These adjustments must bring it about that the total foreign payments and receipts of a country balance at the established rates. In other words, foreign trade must yield a demand and supply of bills which equilibrate at the given rates. The rates must clear the market of bills, and provide a supply equal to the demand. If the rates are not permitted to change materially in response to changes in demand and supply, then the fundamental factors which determine the demand and supply of bills must obviously change. This means alterations of the internal economic structure. Under the former gold standard these alterations tended to be brought about automatically through gold imports and exports.

Flexible exchange rates, on the other hand, while they permit prompt adjustment of rates to changes in the demand or supply of bills, accomplish this sometimes at the cost of rather wide fluctuations in the rates. Such fluctuations are disturbing to exports, imports, and other transactions. Foreign goods, as a result of exchange fluctuations, may become cheap and have a competitive advantage which is temporary and abnormal. Goods exported may become expensive to foreigners, or, on the other hand, may become abnormally cheap. The effects of fluctuations are disturbing, also, to internal prices and to industries that are influenced by the costs of foreign materials. Instability in exchange rates is the source of a great many evils.

A main advantage of permitting flexibility in exchange rates is that this makes possible the pursuit of desired fiscal and monetary policies. Under flexible rates a country may follow a policy aimed toward full production, economic stability, and the counteracting of booms and depressions, as well as other objectives, and not be embarrassed by the necessity of adjusting conditions to a given exchange rate. In order to maintain a fixed rate of exchange, domestic policy has often had to be that of contraction, tight money, falling prices, unemployment, and depression.

If the price level of a country were high in relation to foreign price levels (in terms of fixed exchange rates), foreigners might not buy enough goods from such a country to provide it with an adequate supply of foreign bills. It would, therefore, not be able fully to pay for its imports. Foreign currencies would tend to be at a premium, and gold, if available, would tend to be exported. The exchange rates on such a country would be continually under pressure from abroad. This was the situation facing France from 1931 to September, 1936, when the franc was finally devalued and exchange rates altered. Pressure from abroad on the franc was thereby considerably relieved—but not eliminated because of the continued flight of French capital, and the resulting demand in France for foreign currencies. Devaluation obviated further deflation and lower prices within France, since the price level was brought into harmony with foreign price levels by the new exchange rates. Similarly, when

Great Britain cut loose from fixed rates in 1931, pressure for deflation and lower export prices in Great Britain was relaxed, prices ceased falling, and internal conditions became more prosperous.

The former gold standard and its rigid rates did not provide for the possibility that the internal adjustments often required by such rates might be seriously disturbing, stimulating undue prosperity or causing depression. Flexible exchange rates, on the other hand, recognize that economic instability and other difficulties can result from the maintenance of fixed rates, and that this may be a high price to pay for the benefits of fixed rates. Flexible rates assume that internal stability should come first if a choice must be made.

In view of the widespread adoption of exchange control, nations at present do not permit wide fluctuations in rates. On the other hand, the rates are not fixed sufficiently firmly that parties to a foreign transaction can feel confident that the rates will be the same a few months or even a few weeks later. This system of administered exchange rates has some of the evils of both rigid and free rates, but also has advantages. The rates are not sufficiently secure to give certainty to future transactions, nor are they so flexible that free equilibrium results.

On the other hand, many fluctuations are the result of special situations, flights of capital, speculative and other movements of a temporary nature, and are not in response to fundamental demand and supply conditions. The rates may not reflect equilibrium of a stable or lasting type, based on free choices of consumers, so that the movements, eliminated by exchange control, serve no useful purpose. Furthermore, even though a drastic and perhaps sudden movement of rates reflected a basic change, a gradual and orderly adjustment to the new conditions would be more healthy than a sharp shift.

While administered rates permit gradual adjustment to changing economic conditions, a difficult problem is to know what the rate should be, what rate, everything considered, is most advantageous to the economy. The extreme fluctuations are obviously undesirable, but once a policy of controlling them is embarked upon, it is necessary to decide what rate to main-

tain, the objective being a rate that permits the maximum development of trade and production. The attainment of this objective is undoubtedly promoted by a certain amount of regulation aimed to reduce temporary and unsettling disturbances in rates, but such control is likely to be harmful if it forces or maintains rates very far out of line with underlying conditions, out of line with the free equilibrium rate were the unsettling disturbances removed.

**Exchange Stabilization.**—The problem of stabilizing exchange is more than merely the elimination or reduction of fluctuations. Stabilization has to do with a reduction of fluctuations, but a reduction that takes place without forcing rates or maintaining them at an artificial level which interferes with trade and with a utilization of resources according to comparative advantages. Stabilization thus refers to the reduction or perhaps elimination of fluctuations without altering materially the focal or equilibrium point around which fluctuations tend to center. The problem is made difficult by the fact that this focal point is under most circumstances constantly shifting. To stabilize rates completely and permanently it would be necessary to stabilize this equilibrium point and the real relationship between the currencies in question—not an easy task. If disturbing internal adjustments are to be avoided, some movement of rates may be necessary, unless economies are so geared together that they move in parallel lines. Whatever exchange movement may be necessary under a stabilization program, obviously should be a minimum and as infrequent as possible.

The expression exchange stabilization, it will be noted, has to do with efforts to provide rates that in general and on the average approximate the free equilibrium rate, but which, while following the trend, move as little as possible. Stabilization differs from exchange control, in that rates under exchange control do not necessarily aim to conform to what would be the equilibrium rate, or a moving average of this rate. Furthermore, under stabilization the purchase and sale of bills is relatively free, whereas under exchange control the supply of exchange is rationed by licensing. Exchange stabilization may be carried to



a point of completely rigid rates, with equilibrium forced to adjust itself to the fixed rates. If equilibrium cannot easily so adjust itself, perhaps because of internal conflicting controls, the fixed rates will eventually break down, or a rationing of the available exchange is necessary, and exchange stabilization becomes exchange control. The two terms are thus somewhat similar and the dividing line between their meanings is not always clear cut. Stabilization operations, however, usually aim to regulate the rate by influencing the demand or supply of bills, but leaving the rate relatively free, while exchange control establishes a definite rate, and deals with a lack of equivalence in demand and supply through a system of rationing.

Stability of rates and assurance of the permanency of this stability contribute to the expansion of foreign trade, the investment of capital, and development of resources. In view of the many advantages of stable rates governments have endeavored to provide as much stability as possible, and have set up elaborate machinery for this purpose. Too often, however, governments have desired to maintain a certain level of rates for reasons such as helping importers and others who have foreign payments to make by holding down the price of foreign money or, on the other hand, deliberately depreciating the rates to stimulate exports, or of regarding the previous and accustomed rates as being in some manner especially desirable. In order to maintain desired rates, exchange control has been widely adopted and has resulted in rates that are in many instances far removed from the free equilibrium rate. This variance from the equilibrium rate is evidenced by the necessity of rationing the available supply of exchange. For periods of months and years the official rates, under exchange control, often fail to equilibrate the demand and supply of bills.

With the general abandonment of the gold standard during the nineteen thirties, the system of stable exchange rates limited by the gold points came to an end. Then followed a period of free rates with rather wide fluctuations, which were disturbing to foreign transactions. This condition of erratic exchange movements was relieved somewhat by stabilization operations through the stabilization funds that were set up. This procedure

in turn, partly as a result of wartime necessities in some cases, developed into the system of exchange control and administered rates. These controlled rates cannot, of course, be completely divorced from the demand and supply of bills, but the rates may more or less indefinitely be considerably removed from what would be the free equilibrium rate.

If we assume that the world is to continue with a variety of independent currency units, different monetary systems and fiscal policies, it is necessary to consider what is to be done about currency relationships. The London *Economist* (September 19, 1936) said: "A fixed rate of exchange will never again be the one and only object of economic and social policy. But the full benefits of the new regime will not be reaped until some compromise has been discovered between the rigid system which burst in 1931, and the shifting exchange rates of today."

It has been proposed that the government establish rates as close as possible to the free equilibrium rate, and then hold them at that point, buying and selling exchange freely without restrictions. This involves the difficult task of determining what would be the free equilibrium rate; and also the establishment of foreign exchange or stabilization reserves adequate to maintain the selected rate. This also leaves unsolved the question of what to do when the free equilibrium rate shifts and, when due to this or other causes, reserves are threatened with depletion. To stabilize economies and political conditions so that the free equilibrium rate would continue relatively fixed, is not an easy goal to attain.

Most of the sharp fluctuations that are so troublesome are due to flights of capital and to other more or less temporary and unusual situations, rather than to basic changes in economies; these latter changes come about slowly. This fact indicates the principal field for stabilization, namely, the elimination of fluctuations that will eventually balance each other, insofar as these can be identified. Maintenance of rates which are out of harmony with underlying conditions and which are counter to the trend of economic relationships will ultimately lead to trouble; but efforts to avoid fluctuations that tend to offset each other have a possibility of success. Stabilization efforts should thus

confine themselves to this latter field, and also to smoothing out fluctuations accompanying a change in trend, thereby causing shifts to be more orderly.

If international economic and political stability could be attained or approximated, it should not be impossible to maintain fixed rates between major currencies such as the pound and the dollar for long periods of time, perhaps indefinitely, provided the monetary and fiscal authorities in the two countries cooperated closely and pursued policies not contradictory. Efforts of nations to achieve internal economic and price stability contribute strongly toward exchange stability. Successful and coordinated programs in the different countries would remove much of the apparent inconsistency between fixed exchange rates and internal stability. Considering, however, the practical difficulties, limitations of legislative bodies and governments, and the record of history, a stable and smoothly functioning international order is a good deal to expect, although a worthwhile goal.

The machinery for stabilizing exchange rates centers around so-called stabilization funds: that of Great Britain, known as the Exchange-Equalization Account,<sup>3</sup> has existed since 1932, while that of the United States was created from the profits of gold dollar devaluation in January, 1934, when the fund was established with \$2,000,000,000 of gold. Officials operating these funds enter the market either as buyers or sellers of foreign bills, according as they wish to influence the rates up or down. Since the beginning of the war in 1939 most of the principal rates have been pegged, and the sale of bills in Great Britain has been controlled, so that stabilization there has been replaced by exchange control and rationing, insofar as the two procedures are distinguishable.

The United States has entered into various stabilization agreements with China and several Latin American countries, whereby this country pledged certain sums of money to be available to stabilize rates. For example, the United States agreed with Mexico in November, 1941 to set aside \$40,000,000 to

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<sup>3</sup> After the outbreak of war the resources of this fund were used to pay for necessary imports. See Chapters 37 and 38.

help stabilize the peso-dollar rate. This meant that the United States would, under certain conditions, spend up to \$40,000,000 in purchasing pesos.

If stabilization operations are to be successful, resources must be ample to meet all reasonable demands in both directions. Each country must be in a position to sell freely generous amounts of the other's currency (or have the other country ready to buy its currency); it is always in a position to buy the other's currency by issuing its own money in exchange. It may never be possible to meet unusual and extreme demands caused by the flight of capital and political and economic upheavals, so long as independent currency systems exist. Stabilization funds, however, can be large enough to meet the less extreme emergencies, and to inspire confidence in this ability.

In order for an individual to make payment to a foreign country it is necessary to obtain possession of some of that country's currency. This can be done by exporting merchandise, rendering services, shipping gold, borrowing, or transferring to foreigners credits already abroad. When sudden capital movements create a large demand for a foreign currency, the supply of foreign bills cannot be expanded quickly by the increase of merchandise exports or the rendering of more services. This means that if the capital movements are to be provided for, a supply of foreign currency must be available from one or more of the following sources: funds already abroad and held in reserve for such purpose, gold which can either be shipped abroad or ownership transferred there, liquid assets which can be quickly converted into foreign money, or foreign borrowings.

Historically, gold provided the principal elastic element in the balance of payments and was available to take up the slack, or difference, between export and import items. The burden upon gold became increasingly heavy as capital movements and other international financial transactions grew in size, and as political unrest and threats of war added to the difficulties. Under the previously existing currency mechanisms, the gold that was available, or that was allowed to be exported for settling international balances and stabilizing exchange rates, proved inade-

quate to the task, and exchange rates broke down. Yet only a relatively small portion of monetary gold was called into action in connection with stabilizing exchange rates.

It is an interesting fact that the extraordinarily large movements of capital that preceded the abandonments of the gold standard during the nineteen thirties were provided for to a large extent by means of credit arrangements, and only to a relatively small extent by the physical movement of gold or transfer of ownership through earmarking. In the case of Great Britain, suspension was precipitated by the withdrawal from London during the previous months of funds to the extent of the equivalent of about one billion dollars. Yet during this time the gold reserves of the Bank of England declined by only a little over \$100,000,000. The funds were transferred by a reshuffling of foreign balances and by credit arrangements. A similar situation existed in the case of Japan. The stability of the German currency for a considerable time was maintained by credit devices based upon the so-called "standstill agreements." In the case of Germany, however, while parity was maintained, the balances were not transferred, settlement being postponed. In all these cases, and in pegging of the pound and the franc during the first World War, the purchase and sale of bills was left relatively free. Stability was maintained principally by expanding the supply of foreign money, through credit arrangements, rather than by rationing through licenses.

Under currency systems developed thus far, the means for making international payments have comparatively little elasticity. To overcome this as between Great Britain, other countries, and the United States during the war, lend-lease arrangements were devised to provide such countries with dollars. A nation with large payments to make may be likened to an individual who perhaps has plenty of good assets, but who has little ready cash to meet heavy demands, including demands of creditors that may be presented for immediate payment at any time. The demands of foreign creditors are for cash, which means gold or acceptable foreign credits. Other assets may be used only to a limited extent. A country that is subjected to a run on its currency reserve is as helpless as a bank under the old banking

system in the United States, which might have had sound assets but which was unable to provide cash to meet a serious run, such as took place in 1907. Centralizing the world's currency reserves, and making them available to central banks that may be in need of them, cannot be done as easily as was done by the Federal Reserve System for the United States, in view of political obstacles, but it is in this direction that international currency stabilization is to be sought.

When nations in the past have been subjected to heavy withdrawals of funds and an exchange crisis, other nations have often come to their rescue and advanced funds. Thus Great Britain and France have on different occasions aided each other by loans. The United States has also extended credits to these and other nations to help stabilize the currency or prevent a collapse. The Bank for International Settlements on several occasions lent its aid. Such assistance, however, took place sporadically and no nation knew far in advance just on what it could count. The resulting lack of confidence in the currency encouraged speculative raids.

If transactions between nations are to continue to grow, and if capital is to flow to areas where it can be profitably employed so that the resources of the world can be advantageously utilized, currency relationships must be stabilized. Capital will not seek foreign investment on a large scale when the hazards due to currency uncertainties, in addition to other hazards, are great. Abundant opportunities exist for capital to be put to productive and profitable use, to develop backward areas, expand their purchasing power, and promote the interchange of commodities and services. One of the serious obstacles has been the risks regarding the value of the foreign currency in which investment must be expressed and income paid.

An international currency unit would solve the problem, but such a unit if it is to be secure means an international currency system in a complete and broad sense. This appears to be an impractical goal under present conditions. A firm linking together of the major currency units would accomplish the same result, but would have to contend with the possibility or probability that price movements within the different nations,

or shifts in reciprocal demand, would eventually cause pressure on the rates; the fixed currency relationship would become out of harmony with the free equilibrium rates, as discussed above. The most practical immediate course, however, may be along this latter line, namely, devising stabilization arrangements through the creation of an international agency, and endeavoring to coordinate insofar as possible the economies and policies of the major nations.

Stabilization of the dollar-pound sterling rate would tie together the two leading currencies, and provide the rest of the world with the equivalent of a single international unit. Most of the world's currencies are linked to either one or the other of these units, so that if they are firmly united, other currencies would be largely stabilized. A merger of the sterling area and the dollar area would thus amount to stabilization for most of the world—temporarily, since no arrangements can be secure so long as there exist national economic systems and policies.

Stabilization procedure would necessarily be based upon the existence of funds available to buy or sell currencies freely at the established rates. These funds would need to be large so as to inspire confidence in the rates and prevent speculative raids. Rationing of exchange might be resorted to on rare occasions in times of emergency or crisis, but to the extent that rationing is necessary it represents a failure of stabilization.

The machinery and technique for stabilization can make good use of the world's huge supply of monetary gold, now concentrated very largely in the United States. A gold clearing fund operated by an international agency such as the Bank for International Settlements, would facilitate the settling of balances by debits and credits. Pressure on rates could be met by stabilization loans, if a country's gold or exchange resources were inadequate. Such loans would be legitimate only if efforts were made to deal with the source of the trouble. If the cause were not eliminated, stabilization measures would fail and the rates would eventually have to be altered. In dealing with disturbances and determining stabilization policies, data on the balance of payments of the different countries, price movements, fiscal and other conditions are essential.

The gold that has poured into the United States until little remains in most other countries came as a result of maladjustments and disturbances. Its redistribution, if left to so-called natural forces, would need to be the result of further adjustments and disturbances, assuming the world would take it at all. The United States has little use for gold except as it may be utilized for settling international balances and stabilizing exchange. Here it can serve a worthwhile purpose. If this country, therefore, desires to have the gold used for international clearing, much of the gold must pass into other hands through gold loans by the United States. Foreign countries will doubtless prefer to use their dollar balances in purchasing American goods rather than gold, so that without gold loans for stabilization purposes, little gold would leave the United States. On the contrary, the world's new gold production would continue to flow to this country under existing arrangements and the United States would continue to subsidize this production. The world now has an ample amount of gold, and the matter of checking new gold production, largely from British-owned mines and paid for by the United States, is part of the problem.

Exchange fluctuations and sharp price movements are a symptom of other disorders, so that more important than stable exchange rates or prices is the stabilization of the economic system generally, and at a level approaching full production. This is a broad responsibility for government, but it is a responsibility that cannot be ignored, nor separated from exchange stabilization.

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**GOLD STERILIZATION.**—In view of the very large gold reserves of the United States and the stimulus of new gold additions to credit expansion and to a possible speculative boom, the Secretary of the Treasury announced in December, 1936 a policy of "sterilizing" gold imports. The aim of this policy was to prevent additional gold acquisitions from adding to the already excessively large cash reserves of the banks, and also to provide for meeting an outflow of gold without a drain on the credit resources of the country.



According to this policy, when gold was received either from imports or from new production, the government bought the gold, not by issuing new currency against it, but with existing currency received from the sale of bonds. This amounted to the Treasury giving for the gold, not new currency or bank deposits, but government bonds. Under this policy the Treasury sold an amount of government obligations equivalent to the gold, and set aside the purchased gold in an inactive account. This operation neutralized the effect of the gold upon bank reserves, since through the sale of government obligations funds were withdrawn from the market and held idle in the Treasury.

Conversely, according to this policy, an outward movement of gold could be offset, through the purchase in the market by the Treasury of government obligations, thereby restoring funds to the market that would be lost as a result of the gold exports. Operations of this type thus sterilize gold acquisitions, and neutralize the effects of both gold imports or exports, preventing them from interfering with the monetary policy being pursued. If credit expansion is desired, sterilized gold can be released, as was done in April, 1938, by depositing it (or gold certificates) in the Federal Reserve Banks. The sterilization policy was continued only a short time in view of the increase in the debt caused thereby and in view of the depressed state of business which developed.

The British stabilization fund operated in this same manner, so that gold movements in and out of Great Britain had little or no effect upon commercial bank reserves there unless the authorities so chose. When the British fund bought gold it sold Treasury bills, so that the cash coming into the market from the purchase of the gold was withdrawn through the sale of the bills. When gold was exported Treasury bills were bought, so the market neither lost nor gained as a result of gold movements.

## CHAPTER 15

### HISTORY OF INTERNATIONAL-TRADE THEORY: EARLY DOCTRINES

The doctrines of international trade which are generally accepted today are the result of a long evolutionary process. They have been sifted and debated until today the differences of opinion regarding them are much less pronounced than are the similarities. A study of the history and development of international-trade theory aids in understanding present-day theory and problems. The next three chapters, therefore, are devoted to a brief history of international-trade theory.

**Ancient Thought.**—Many modern ideas on trade, domestic and foreign, can be traced to ancient times. Scattered references to trade appear in the Old Testament,<sup>1</sup> but most of these passages are of interest as indicating merely the existence and extent of trade in this early period rather than as giving Hebrew views on trade.

The fact that trade takes place according to natural advantages was well understood in Greek and Roman times. Literature of that period points out that inherent differences between peoples and kingdoms made trade of mutual benefit. Specialization and trade were recognized as being profitable to both parties, since resources and conditions in the different regions were varied.

Plato (c. 428-c. 348 B.C.), on several occasions referred to trade. His ideas on commerce do not always appear consistent, but the contradictions are perhaps more apparent than real. He did not have a high regard for the business of making money,

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<sup>1</sup> See *Genesis*, 34: 10, 21; *Genesis*, 46: 32. An especially interesting passage may be found in *Ezekiel*, 27.

and declared that "there are in all three things about which every man has an interest; and the interest about money, when rightly regarded, is the third and lowest of them: midway comes the interest of the body; and, first of all, that of the soul."<sup>2</sup> Plato regarded the division of labor and trade as necessary and useful, but did not hold in much esteem the traders of his day. His views on the division of labor are found in *The Republic*. He points out that "we are not all alike; there are diversities of natures among us which are adapted to different occupations." He significantly concludes that "all things are produced more plentifully and easily and of a better quality when one man does one thing which is natural to him and does it at the right time, and leaves other things."<sup>3</sup>

Plato shows that where there is specialization, there must be markets, trade, and merchants. In the dialogue between Socrates and Adeimantus occurs this interesting passage:

"... to find a place where nothing need be imported is well nigh impossible."

"Impossible."

"Then there must be another class of citizens who will bring the required supply from another city?"

"There must."

"But if the trader goes empty-handed, having nothing which they require who would supply his need, he will come back empty-handed."

"That is certain."

"And therefore what they produce at home must be not only enough for themselves, but such both in quantity and quality as to accommodate those from whom their wants are supplied."

"Very true."

"Then more husbandmen and more artisans will be required?"

"They will."

"Not to mention the importers and exporters, who are called merchants?"

"Yes."

"Then we shall want merchants?"

"We shall."

<sup>2</sup> *Laws*, Bk. V (Jowett translation). The statements here attributed to Plato are made by characters in Plato's dialogues, but it is clear from the context in each case that the statements reflect Plato's own views.

<sup>3</sup> *The Republic*, Book II (Jowett translation).

"And if merchandise is to be carried over the sea, skillful sailors will also be needed, and in considerable numbers?"

"Yes, in considerable numbers."

"Then, again, within the city, how will they exchange their productions? . . ."

"Clearly they will buy and sell."

"Then they will need a market-place and a money-token for purposes of exchange."

"Certainly."

"Suppose now that a husbandman, or an artisan, brings some production to market, and he comes at a time when there is no one to exchange with him—is he to leave his calling and sit idle in the market-place?"

"Not at all; he will find people there who, seeing the want, undertake the office of salesmen." <sup>4</sup>

In *The Laws*, Plato again defends trade. "Retail trade," he writes, "is not by nature intended to do any harm, but quite the contrary; for is not he a benefactor who reduces the inequalities and incommensurabilities of goods to equality and common measure?" Why, then, he asks, has retail trade been "brought into ill-odor?" He answers that it is because the mass of men are selfish; "their desires are unbounded, and when they might gain in moderation they prefer gains without limit; wherefore all that relates to retail trade, and merchandise, and the keeping of taverns, is denounced and numbered among dishonorable things." <sup>5</sup>

On the subject of foreign trade, Plato's ideas are less clear-cut. He appears to have looked upon foreign trade with some distrust and to have regarded self-sufficiency as a laudable goal. The following quotation illustrates his attitude:

The sea is pleasant enough as a daily companion, but has indeed also a bitter and brackish quality, filling the streets with merchants and shopkeepers. . . . There is a consolation, therefore, in the country producing all things at home; and yet, owing to the ruggedness of the soil, not providing anything in great abundance. Had there been abundance, there might have been a great export trade, and a great

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<sup>4</sup> *The Republic*, Book II.

<sup>5</sup> *Laws*, Book XI.

return of gold and silver; which, as we may safely affirm, has the most fatal results on a state whose aim is the attainment of just and noble sentiments.<sup>6</sup>

This passage is in harmony with Plato's tendency to subordinate economic affairs to other "higher" interests. While not wishing a thriving foreign commerce, Plato nevertheless favored free trade.

Let no one pay any duty either on the importation or exportation of goods; and as to frankincense and similar perfumes, used in the service of the gods, which come from abroad, and purple and other dyes which are not produced in the country, or the materials of any art which have to be imported, and which are not necessary—no one should import them; nor, again, should any one export anything which is wanted in the country.<sup>7</sup>

The views of Aristotle (384–322 B.C.) on trade are very similar to those of Plato. Like Plato, Aristotle did not have a high opinion of the making of money, holding that "it was easy for philosophers to be rich if they chose it, but that that was not what they aimed at."<sup>8</sup>

Anticipating Adam Smith by many centuries, Aristotle clearly distinguished between money and wealth. He asserted that "wealth is very often supposed to consist in the quantity of money which any one possesses, as this is the medium by which all trade is conducted and a fortune made," but repudiated this notion, pointing out that "he who abounds in money often wants necessary food; and it is impossible to say that any person is in good circumstances when with all his possessions he may perish with hunger."<sup>9</sup>

The early Christian philosophers accepted the advantages of trade and gave trade a theological basis. They proclaimed that God made the different regions to have different resources and products so that men could have trade relations one with another and thereby become a united and harmonious community, helping each other and living in brotherly love under one God. This

<sup>6</sup> *Laws*, Book IV.

<sup>7</sup> *Laws*, Book VIII.

<sup>8</sup> Aristotle, *Politics* (translation by William Ellis), Book I, Ch. XI.

<sup>9</sup> *Ibid.*

religious aspect of international-trade doctrine, that trade is ordained of God and that men are in need of each other's aid, had a long history, and was even used by mercantilists and later writers, when convenient, to lend support to their views. At the same time the Church regarded trade with some misgivings, particularly during the Middle Ages.

**Medieval Thought.**—The economic thought of the Middle Ages is found largely in the writings of the Church fathers. They did not write treatises on economics, as such, but touched upon economic subjects in dealing with broader issues. During the early Middle Ages, when economic life was marked by a high degree of local self-sufficiency, trade was regarded with suspicion by leaders of the Church, such as Chrysostom (c. 345–407) and Cassiodorus (c. 490–585), who felt that trade for gain was in essence sinful. Trade was by its very nature barren, and traders did not produce anything. With the rise of towns and the emergence of a large merchant class, this distrust of trade gradually broke down. The revival of interest in the writings of the Greeks, which opened the Renaissance, greatly influenced the thinkers of the Church, and the resulting mixture of Christian doctrine and Greek thought (particularly that of Aristotle) is known as scholasticism.

The greatest of the scholastic writers was Thomas Aquinas (1225–1274). His famous work, the *Summa Theologica*, contains his ideas on trade. He regarded trade with favor, holding that “buying and selling seem to have been instituted for the common advantage of both parties, since one needs something that belongs to the other, and conversely, as explained by the Philosopher [Aristotle].”<sup>10</sup> Aquinas devoted much space to a discussion of the conditions under which trade is just or unjust. He dealt with such questions as “whether a man may lawfully [*i.e.*, justly] sell a thing for more than it is worth,” “whether a sale is rendered unlawful by a defect in the thing sold,” and “whether a seller is bound to declare a defect in a thing sold.”<sup>11</sup>

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<sup>10</sup> *Summa Theologica*, Question LXXVII, as quoted in Arthur Eli Monroe, *Early Economic Thought*, Cambridge, Harvard University Press, 1924, p. 54.

<sup>11</sup> The clauses in quotation marks are titles of sections in the *Summa Theologica*.

In answering these questions, he was guided by the medieval doctrine of the "just price." It was believed by medieval thinkers that for every article there is a just price, above or below which the article should not be sold. The just price, according to this doctrine, is that which covers cost of production but no more. In reply to the question "whether in trading it is lawful to sell a thing for more than was paid for it," Aquinas declared that such action is legitimate if the seller "has improved the thing in some way" or if "the price has changed with a change of place or time" or if there is risk "in transporting the thing from one place to another."<sup>12</sup>

**Origin and Nature of Mercantilism.**<sup>13</sup>—The earliest extensive body of literature dealing with the theory of international trade appeared in connection with the ideas of the so-called mercantilists, who date from the sixteenth to the latter part of the eighteenth centuries. The mercantilists were statesmen and economic thinkers in England and on the Continent who developed certain doctrines regarding the state, commerce, the precious metals, and other matters. They placed great stress upon the condition of a country's foreign trade. Their ideas, now regarded as largely fallacious, found expression in governmental policies, and still exert an influence upon popular opinion and political action.

In order to understand the nature of mercantilism, it is necessary to know something of the historical setting out of which it emerged. Economic life during the Middle Ages was almost entirely of a local nature. Each feudal manor and each town was a self-sufficient unit, in which was produced almost all that was consumed. Such trade as existed, domestic as well as foreign, was on a relatively small scale, and was confined largely to luxuries. Trade was hindered from expanding by various types of restrictions and barriers, particularly on the Continent. The commercial policies of towns were very much like the nationalistic policies of today. Each town attempted to control the trade of the surrounding countryside and to obstruct

<sup>12</sup> *Summa Theologica*, Question LXXVII, as quoted in Monroe, *op. cit.*, p. 64.

<sup>13</sup> See also Chapter 7 on the "Balance of International Payments."

the trade of competing towns. The free flow of goods was impeded by numerous tolls on rivers, highways, and at provincial boundaries. On the main rivers were toll stations ordinarily every six to nine miles; on the Rhine, the main trade route in central Europe, there were in the fourteenth century over sixty such stations.<sup>14</sup>

The economic philosophy of the Middle Ages thus emphasized local self-sufficiency. Well before the end of this period, however, forces were operating to change this situation. The Crusades, the discovery of the New World, the development of a monetary economy, and other developments led to the breakdown of local self-sufficiency and to the rise of strong national states, first Spain and Portugal, then Holland, France, and England. The emergence of the mercantilist philosophy coincided with these developments. The essence of mercantilism, according to Gustav Schmöller, was "state-making" by means of policies aimed to bring about national economic unity.<sup>15</sup> Thus mercantilist statesmen, such as Colbert in France, worked assiduously for the removal of barriers to local trade, endeavoring to establish a vigorous nationalism in the place of deeply rooted localism.

A central motive of mercantilism, then, was to achieve a powerful and wealthy state. The interests of the individual—particularly the interests of the laboring classes—were subordinated to this end. Private endeavor was subjected to numerous regulations and restrictions which were thought to advance the well-being and strength of the state. France went especially far in curbing individual freedom and in controlling commerce and industry. Wages were fixed by the state as were many prices. The state decided who should work, what should be made, and how it should be made. Infractions were severely punished.

A cardinal mercantilist doctrine was that a nation, to be strong and prosperous, should have a large amount of gold and

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<sup>14</sup> Eli F. Heckscher, *Mercantilism*, Vol. I, London, George Allen & Unwin, Ltd., 1935, p. 57. This comprehensive treatise is useful for those who are interested in a detailed treatment of mercantilist thought and practice.

<sup>15</sup> Schmöller, *The Mercantile System and Its Historical Significance*, 1884; reprinted in English by Peter Smith, New York, 1931, p. 50.



silver, or treasure as it was called. The reasons which the mercantilists advanced for this belief vary, and are at times contradictory. Some writers, stressing the desirability of thrift, held that the precious metals represented the most permanent, most liquid, and most dependable form of wealth. These writers tended to think of money as synonymous with wealth. Others held that a large supply of money resulted in low interest rates, which were regarded as important for prosperity.<sup>16</sup> Many mercantilists were merely inflationists, and favored an expanding monetary supply as a means of maintaining business at peak levels. These writers stressed the need for keeping money in continuous circulation.<sup>17</sup>

In order to secure as large a supply of the precious metals as possible, mercantilists held that merchandise exports should exceed merchandise imports in value, so that a continuous inflow of bullion would result. This they called a "favorable" balance of trade, whereas an excess of merchandise imports was called an "unfavorable" balance. This terminology has, unfortunately, continued to the present day, and is often the source of popular misconceptions.

An excess of exports over imports was also advocated as a means of increasing domestic employment. Imported goods, it was held, are produced by foreign rather than by domestic labor, and in many cases compete with products made by home labor. To achieve a maximum of domestic employment, it was therefore maintained that exports should be as large, and imports as small, as possible. This fallacious argument is still advanced in much the same form by advocates of tariff protection. On similar grounds, mercantilists argued that, so far as possible, exports should consist of manufactured goods rather than raw

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<sup>16</sup> For a sympathetic interpretation of mercantilism, concerned particularly with the mercantilist attitude toward interest rates and related matters, see John Maynard Keynes' chapter, "Notes on Mercantilism, etc.," in his *General Theory of Employment, Interest, and Money*, New York, Harcourt, Brace & Co., 1936. Keynes' treatment of mercantilism should be compared with the less favorable studies of Heckscher (*op. cit.*) and of Jacob Viner (*Studies in the Theory of International Trade*, New York and London, Harper & Bros., 1937, Chs. I and II).

<sup>17</sup> For example, Charles Davenant, a British mercantilist, wrote in 1698 that "there must be a quick stock [of money] running among the people; and always where that stock increases, the nation grows strong and powerful." Quoted in Heckscher, *op. cit.*, Vol. II, p. 218.

materials, since manufactured goods employ more labor and command higher prices.

To achieve a favorable balance of trade, mercantilists were thorough-going protectionists. In an effort to keep imports at a minimum, heavy tariffs and other restrictions were therefore imposed. At the same time, export industries were given bounties and other forms of encouragement. Shipping was also subsidized in order to help stimulate foreign trade.

The colonial policy of mercantilism has been discussed in a previous chapter.<sup>18</sup> Colonies were regarded by mercantilists as sources of raw materials and as markets for the manufactures of the mother country. To prevent colonial trade from being diverted to other countries, strict navigation laws were enacted, and powerful commercial companies established.

Mercantilists as a group were little concerned with the living standards of the masses or with social aspects of these questions. In fact, they advocated a large population to insure low wages, and not only condoned but extolled child labor, on the grounds that it would make children industrious and also keep them out of mischief.<sup>19</sup> Their main emphasis was on selling rather than on buying, on money rather than on goods, and on national power rather than on individual welfare. It is little wonder that Adam Smith accused the mercantilists of preaching a doctrine which was merely a program to enrich the merchant and manufacturer at the expense of the general public.

**British Mercantilists.**—British mercantilism was of a somewhat more moderate character than that on the Continent. Its chief emphasis was upon the promotion of foreign trade rather than upon the minute regulation of domestic industry; thus it differed considerably from mercantilist thought and practice in France. A principal reason for this is the fact that local barriers to domestic trade had been largely eliminated in England by the end of the thirteenth century, while in France they persisted until after the French Revolution.

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<sup>18</sup> Chapter 2, "History of International Trade."

<sup>19</sup> An interesting discussion on this subject is found in Heckscher, *op. cit.*, Vol. II, pp. 155-157.

In England, mercantilist writers were not, as a rule, academic men or statesmen but rather merchants and manufacturers. This fact lends support to Adam Smith's interpretation of mercantilism as a doctrine inspired by producer self-interest.

One of the earliest important British writers on mercantilism was Gerald Malynes, whose chief volume on foreign trade was published in 1622. Malynes' work is typical of early mercantilist thought in its emphasis on the importance of money. He held that money possesses "intrinsic" value.<sup>20</sup> Contending that exportation of the precious metals was harmful to a country's trade, he advocated that government have a monopoly over foreign-exchange transactions and prohibit the export of bullion by law. His work contains many of the cruder fallacies of mercantilism.

The writings<sup>21</sup> of Thomas Mun (1571-1641) reveal a considerably clearer understanding of the nature of international trade. While Mun shared with many mercantilists a tendency to regard money and wealth as identical, he did not, like Malynes, advocate prohibition of specie exports. On the contrary, he held that the exportation of gold and silver was not harmful if it was merely temporary and if it did not interfere with an excess of merchandise exports. Mun argued that the proper way to increase a nation's supply of the precious metals was through a favorable balance of trade. He wrote:

I will take that for granted which no man of judgment will deny, that we have no other means to get treasure but by foreign trade, for mines we have none which do afford it, and how this money is gotten in the managing of our said trade I have already showed, that it is done by making our commodities which are exported yearly to over-balance in value the foreign wares which we consume. . . .<sup>22</sup>

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<sup>20</sup> Like many mercantilists, however, Malynes was not unaware of the effect of the quantity of money on prices. He wrote that "plenty of money maketh generally things dear, and scarcity of money maketh likewise generally things good cheap." From Malynes' *Treatise of the Canker of England's Common Wealth* (1601), as quoted in Viner, *op. cit.*, p. 41.

<sup>21</sup> *A Discourse of Trade* (1621); *England's Treasure by Foreign Trade* (written about 1630; published posthumously in 1664).

<sup>22</sup> *England's Treasure by Foreign Trade*, as quoted in Arthur Eli Monroe, *op. cit.*, p. 171. Spelling in these quotations has been modernized.

Although not the first to recognize the existence of invisible items in the balance of international payments, Mun, writing about 1630, listed most of the items that would now be included.<sup>23</sup>

The next British mercantilist writer of prominence was Sir William Petty (1632–1687), whose views are similar to those of Mun. With Mun, he attached the utmost importance to money, and advocated its increase through a favorable balance of trade. His emphasis upon the importance of the precious metals is revealed in the ensuing quotation, which is typical of mercantilist thought:

The great and ultimate effect of trade is not wealth at large, but particularly abundance of silver, gold, and jewels, which are not perishable, nor so mutable as other commodities, but are wealth at all times, and all places; . . . so as the raising of such, and the following of such trade, which does store the country with gold, silver, jewels, etc., is profitable before others.<sup>24</sup>

Petty was what might be called a moderate mercantilist, and some of his opinions foreshadow the liberal doctrines of Adam Smith. In his *Treatise of Taxes and Contributions* (1662), he wrote:

We must consider in general, that as wiser physicians tamper not excessively with their patients, rather observing and complying with the motions of nature than contradicting it with vehement administrations of their own, so in politics and economics the same must be used.<sup>25</sup>

The views of Sir Josiah Child (1630–1699) are of interest because they represent the opinions of one of the leading merchants of that time. Child was Governor of the British East India Company, and was an ardent mercantilist. His vigorous assertions on matters of trade state in clear form the principal doctrines of English mercantilism. "Foreign trade," he wrote, "produces riches, riches power; power preserves our trade and

<sup>23</sup> *England's Treasure by Foreign Trade*, Ch. XX.

<sup>24</sup> *Essays in Political Arithmetic* (1665).

<sup>25</sup> Quoted in Viner, *op. cit.*, p. 98.

religion.”<sup>26</sup> In common with other mercantilists, he advocated a large population; “it is in multitudes of people, and good laws, such as cause an increase of people, which principally enrich any country.”<sup>27</sup> He also contended that trades involving the greatest amount of shipping should receive most encouragement, because “the freight, which is in such trades often more than the value of the goods, is all profit to the nation.”<sup>28</sup> Particularly characteristic of mercantilist thought is Child’s statement concerning the relative value to a nation of various types of labor. He declared:

It is (I think) agreed on by all that merchants, artificers, farmers of land and such as depend on them . . . are the three sorts of people which by their study and labor do principally if not only, bring in wealth to a nation from abroad; other kinds of people, viz. nobility, gentry, lawyers, physicians, scholars of all sorts, and shopkeepers, do only hand it from one to another at home.<sup>29</sup>

**Continental Mercantilists.**—The theory of mercantilism appears to have been first systematically developed by an Italian, Antonio Serra. Serra’s *Brief Treatise on the Causes Which Can Make Gold and Silver Plentiful in Kingdoms Where There Are No Mines* was published in 1613. In it, Serra argued that a country without gold and silver mines could secure these metals only by achieving an excess of exports of raw products or manufactures. Exports, he contended, should preferably be manufactures, since these command higher prices.

In France, mercantilist practices were probably carried to greater extremes than in any other country. Under Colbert (1619–1683), Controller-General of the Finances under Louis XIV, industry was subjected to minute regulation. The state decreed who could work, what could be manufactured, and what materials and processes could be used. Machines were broken and products burned which did not comply with the rules. In many cases, artisans were not free to choose the location where they might establish themselves. As a partial compensation for

<sup>26</sup> Quoted in Viner, *op. cit.*, p. 112.

<sup>27</sup> Child, *A Discourse about Trade* (1690).

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*

these measures, technical schools were established, canals built, and a large portion of the internal trade barriers were abolished. At the same time, tariffs on imports from abroad were levied which practically excluded foreign manufactures. Colbert regarded the state as an *entrepreneur*, whose function it was to direct and apportion the resources of a nation in much the same fashion as a business man would manage the affairs of his own firm.

In Germany, mercantilist doctrines were expounded by the so-called cameralists (derived from camera, meaning a prince's treasury or public office). Unlike English mercantilists, whose opinions appear chiefly in pamphlets or short volumes, the cameralists expressed their ideas in large comprehensive treatises, which were concerned not only with economic matters but with the science of government, law, technology, mining, and related subjects. In common with British and French mercantilists, the cameralists advocated a large population, and regarded the precious metals as the most desirable form of wealth. In a typically cameralist work, *Austria over All* (1684), Philipp von Hörnigk (1638-1712) laid down nine "fundamental rules of national economy," which reveal something of the general tenor of German mercantilism. These nine rules for the building of a strong state were:

First, to inspect the country's soil with the greatest care, and not to leave the agricultural possibilities of a single corner or clod of earth unconsidered. . . . Second, all commodities found in a country, which cannot be used in their natural state, should be worked up within the country. . . . Third, . . . attention should be given to the population, that it may be as large as the country can support. . . . Fourth, gold and silver once in the country . . . are under no circumstances to be taken out for any purpose . . . or allowed to be buried in chests or coffers, but must always remain in *circulation*. . . . Fifth, the inhabitants of the country should make every effort to get along with their domestic products. . . . Sixth, in case the said purchases were indispensable . . . they should be obtained from these foreigners at first hand . . . in exchange for other domestic wares. . . . Seventh, such foreign commodities should in this case be imported in unfinished form. . . . Eighth, opportunities should be sought night and day for selling the country's superfluous goods to

these foreigners in manufactured form. . . . Ninth, except for important considerations, no importation should be allowed under any circumstances of commodities of which there is a sufficient supply of suitable quality at home. . . .<sup>30</sup>

**Adam Smith and the Decline of Mercantilism.**—The year 1776 marked the publication by Adam Smith (1723–1790), of his well-known economic treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations*. The target of this lengthy volume was the “mercantile system,” which the author subjected to searching and pitiless scrutiny.<sup>31</sup>

The time was ripe for a bold attack upon the dogmas of mercantilism. The system was already tottering, though perhaps few sensed that its days were numbered. During the second half of the eighteenth century, machines were invented and processes developed which were to revolutionize industry, bringing undreamed benefits, and also problems. If mercantilism, as Schmöller suggested, represented a transition from local to national economy, the Industrial Revolution released forces which were to operate in the direction of world economy. Mechanical processes were introduced which, to be profitable, made necessary minute division of labor and vastly increased markets to absorb the vastly increased output. In the face of these developments, the restrictionist policies of mercantilism were to fall of their own weight. At the same time, the doctrines of Adam Smith were to form the basis of the new policy of non-interference, or *laissez-faire*.

Smith was professor of moral philosophy at the University of Glasgow, and is frequently referred to as “the founder of political economy.”

Smith's contribution to economic thought is of both a negative and a positive character. On the negative side, he dealt a death-blow to mercantilist doctrines in the English-speaking world, even though these doctrines were already beginning to fall into disrepute. One or two quotations will reveal the char-

<sup>30</sup> As quoted in Monroe, *op. cit.*, pp. 223–225.

<sup>31</sup> It is interesting to note that the title of Smith's book is similar to those of a number of mercantilist works. This reflects the fact that Smith was in sympathy with the mercantilist goal of a strong, wealthy state, though in emphatic disagreement with the means which mercantilists advocated toward this end.

acter of his verbal attack, in which he accused the mercantilists of selfish, ulterior motives. He wrote:

It cannot be very difficult to determine who have been the contrivers of this whole mercantile system; not the consumers, we may believe, whose interest has been entirely neglected; but the producers, whose interest has been so carefully attended to; and among this latter class our merchants and manufacturers have been by far the principal architects.<sup>32</sup>

Smith devoted much space to a condemnation of the mercantilist preoccupation with money in preference to other forms of wealth. He stressed repeatedly that money is of value solely as a means for satisfying wants and in itself is of no significance. In an ironic vein, he declared:

It is not for its own sake that men desire money, but for the sake of what they can purchase with it. Consumable commodities, it is said, are soon destroyed; whereas gold and silver are of a more durable nature, and, were it not for this continual exportation, might be accumulated for ages together, to the incredible augmentation of the real wealth of the country. Nothing, therefore, it is pretended, can be more disadvantageous to any country than the trade which consists in the exchange of such lasting for such perishable commodities. We do not, however, reckon that trade disadvantageous which consists in the exchange of the hardware of England for the wines of France and yet hardware is a very durable commodity, and were it not for this continual exportation might, too, be accumulated for ages together, to the incredible augmentation of the pots and pans of the country.<sup>33</sup>

The chief positive contribution of Smith to the theory of international trade was an impressive exposition of the benefits of international specialization and division of labor, and, consequently, of free trade. Smith clearly perceived that freedom of trade permits a country to specialize in the production of those goods for which it is best fitted, making possible a higher standard of living for all countries. He wrote:

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<sup>32</sup> *Wealth of Nations* (Everyman's edition), Bk. IV, Ch. VIII (Vol. II, p. 156).

<sup>33</sup> *Op. cit.*, Book IV, Ch. I (Vol. I, p. 385).



By means of glasses, hotbeds, and hot walls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines merely to encourage the making of claret and burgundy in Scotland? But if there would be a manifest absurdity in turning towards any employment thirty times more of the capital and industry of the country than would be necessary to purchase from foreign countries an equal quantity of the commodities wanted, there must be an absurdity, though not altogether so glaring, yet exactly of the same kind, in turning towards any such employment a thirtieth, or even a three-hundredth part more of either. Whether the advantages which one country has over another be natural or acquired is in this respect of no consequence. As long as the one country has those advantages, and the other wants them, it will always be more advantageous for the latter rather to buy of the former than to make.<sup>34</sup>

In striking contrast to the mercantilists, Smith held that if men were permitted freely to pursue their private economic interests in their own way, the economic interests of society would be served in the most effective possible manner—far more effectively than under a restrictive system. He summarizes this argument in a famous paragraph:

As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labors to render the annual revenue of society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it . . . by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.<sup>35</sup>

Smith's influence upon his contemporaries was great. While it would not be true to say that his doctrines were responsible

<sup>34</sup> *Op. cit.*, Book IV, Ch. II (Vol. I, pp. 402-403).

<sup>35</sup> *Ibid.*, Book IV, Ch. II (Vol. I, p. 400).

for the overthrow of the mercantile system, the spread of his ideas did much to hasten its downfall. British political thought and policy during the nineteenth century were profoundly affected by Smith's views, and *The Wealth of Nations* played an important part in shaping the thinking of most of the theorists whom we shall consider in the next chapter.

## CHAPTER 16

### HISTORY OF INTERNATIONAL-TRADE THEORY: THE ENGLISH CLASSICAL SCHOOL

In the preceding chapter, the evolution of international-trade theory and the beginnings of so-called "classical economics," as it concerned foreign trade, were briefly traced up to the close of the eighteenth century. The present chapter deals with developments in trade theory made by the English<sup>1</sup> "classical school" during the nineteenth century. Until recent years, the English classical theory of international trade was almost universally accepted. Although writers on the Continent vigorously denied various assumptions and conclusions of the English school, they did not succeed in building a comprehensive rival theory. Their work was mainly of a critical or negative character.

**David Ricardo.**—Outstanding in the development of classical theory was David Ricardo (1772–1823). Born in England, the son of a Dutch Jew who had settled in England and become wealthy there, Ricardo became a stock broker and acquired a considerable fortune of his own by the time he was twenty-five. He later devoted much of his time to the study of economic questions, and for a while served as a member of Parliament, where his advice was frequently sought on financial matters. His *Principles of Political Economy and Taxation*, containing his views on foreign trade, was published in 1817. Ricardo's contribution to the theory of international trade was noteworthy, and a large part of subsequent work in this field by British and American economists has consisted merely of refinements or modifications of the Ricardian theories. Many modern economists, however, consider the whole classical approach unsound, as noted in the next chapter.

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<sup>1</sup> The English classical school included Irish and British writers.

In his analysis of domestic trade, Ricardo adhered to a labor theory of value, which has long since been generally discarded by economists. He held that the value of a good is proportional to the amount of labor expended in its production; that where free competition prevails, the ratios at which goods exchange are determined by the relative amounts of labor required for their production. An article which requires twice as much labor to produce as another would, according to this doctrine, sell for twice the price. Values, i.e., exchange values, were considered as determined by costs of production; and costs were resolved into amounts of labor.<sup>2</sup>

On the basis of this theory of value, Ricardo made a sharp distinction between domestic and foreign trade. Within a single country, he maintained, goods would exchange at ratios which reflected the labor costs of the goods. This would come about as a result of free competition and unrestricted movement of labor and capital. Thus if an article sold at a price which was high in relation to its labor costs, competition to produce and sell the article would force the price down. Labor and capital would flow to the industry or locality where prices were high, and thereby keep prices in harmony with costs, i.e., labor costs. This condition of free competition and mobility of labor and capital within a country being assumed, Ricardo held that all domestic production and trade would be on a basis of absolute advantage (though he did not use this term). That part of a country which could produce a particular good with the smallest amount of labor would specialize in the production of that good (since no other region could compete successfully), exchanging it for goods from other areas which would also produce under conditions of absolute advantage. Labor and capital would flow to those industries and locations where the advantages were the greatest.

Trade between countries, however, Ricardo maintained, is of a fundamentally different character, being governed neither by labor cost nor, necessarily, by absolute advantage. He wrote:

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<sup>2</sup> Ricardo was conscious of the existence of differences in the quality of labor, as well as of differences in reward, in various occupations in the same country.

The same rule which regulates the relative value of commodities in one country does not regulate the relative values of the commodities exchanged between two or more countries. . . . The labor of 100 Englishmen cannot be given for that of 80 Englishmen, but the produce of the labor of 100 Englishmen may be given for the produce of 80 Portuguese, 60 Russians, or 120 East Indians.<sup>3</sup>

How is this difference to be explained? It results, said Ricardo, from the fact that capital and labor do not flow freely across national boundaries.

Experience . . . shows that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connections, and entrust himself, with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings . . . induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations.<sup>4</sup>

If capital and labor flowed freely from one country to another in response to changes in profits and wages, international trade in commodities, if free, would not differ essentially from domestic trade. All commodities would be produced under conditions of absolute advantage, and would be exchanged, according to Ricardo, at ratios corresponding to the relative quantities of labor involved in their production. Labor and capital would leave a poor country that had no advantages, and seek countries where advantages were greater. The lack of such a free flow of the factors of production between different countries, however, alters the whole picture. Goods of one country, requiring a large quantity of labor to produce, may exchange for goods of another country requiring but a small amount of labor. Plainly, labor cost does not govern the terms of exchange in foreign trade. What, then, determines these terms? The answer, according to Ricardo, is *comparative* cost.

Ricardo's chief contribution to the theory of international

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<sup>3</sup> *Principles of Political Economy and Taxation*, G. Bell & Sons, Ltd., London, 1932, Ch. VII, pp. 113, 116.

<sup>4</sup> *Op. cit.*, pp. 116, 117.

trade is his exposition of this concept.<sup>5</sup> According to the doctrine of comparative costs, each country tends to specialize and to export commodities in the production of which it has a comparative (not necessarily an absolute) advantage. This advantage is measured in terms of real costs, which are resolved into labor costs, consistent with the labor theory of value.

Ricardo explained this principle by means of a simple illustration involving two countries, England and Portugal, and two commodities, cloth and wine. Assume, said Ricardo, that a given quantity of cloth requires 100 days of labor to produce in England and 90 days of labor to produce in Portugal. Assume also that a given quantity of wine requires 120 days of labor to produce in England and 80 days of labor in Portugal. In this situation, it would pay England to specialize in the production of cloth and exchange it for wine, since she could thus acquire, with 100 days of labor, wine that it would take 120 days of labor to produce in England. At the same time, it would pay Portugal to specialize in the production of wine and exchange it for cloth, since Portugal could thus acquire with 80 days of labor cloth that would take 90 days of labor to produce in Portugal. It is advantageous for Portugal to specialize in wine, even though she has an absolute advantage in the production of both commodities—that is, even though she can produce both articles with a smaller expenditure of labor than can England.

Here we have a situation where trade is profitable, not because of absolute advantage, but because of comparative advantage. Each country, Ricardo noted, secures more through specialization and trade than if it failed to specialize, even though one of the countries, England, produces and exports a commodity (cloth) which can be produced at absolutely lower cost (real cost) elsewhere, while the other country, Portugal, does *not*

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<sup>5</sup> Ricardo himself did not use the term "comparative cost." There has been some debate as to whether credit for introducing the concept of comparative advantage as opposed to absolute advantage should be given to Ricardo or to Robert Torrens. Torrens had presented a fairly satisfactory statement of the doctrine in an essay published in 1815, two years before the appearance of Ricardo's treatise. Professor Viner, admitting the priority of Torrens' statement, writes: "It is unquestionable, however, that Ricardo is entitled to the credit for first giving due emphasis to the doctrine, for first placing it in an appropriate setting, and for obtaining general acceptance of it by economists." (*Studies in the Theory of International Trade*, p. 442.)

produce a commodity (cloth) when it has an *absolute* advantage (lower real cost), in its production. This situation of trade based on comparative advantage would disappear, Ricardo pointed out, were capital and labor to flow freely between the two countries. In the latter event, capital and labor would migrate to Portugal so long as conditions for production there were more advantageous than in England. After capital and labor ceased to flow, specialization and trade would still very likely continue due to variations in resources and other conditions, but it would be on a basis of absolute rather than comparative advantage.

Ricardo thus showed clearly that international trade need not be on a basis of absolute advantage. A country may find it profitable to specialize in the production of goods which can be produced with far less effort elsewhere, or, on the other hand, may find it comparatively unprofitable to specialize in the production of goods in which it has an absolute advantage, since it may have a still greater advantage in other goods.

Significant as this contribution is, it leaves unanswered the important question of how the actual ratios at which goods exchange are determined. Furthermore, the emphasis upon cost, particularly labor cost, is misleading and inaccurate, as will be seen in the next chapter. In his illustration, Ricardo helped to explain the conditions under which specialization and trade would be profitable—that is, why trade would take place—but he did not explain what the actual terms of trade would be or how they are determined—that is, why just so many yards of cloth trade for so many bottles of wine. This latter task was undertaken by J. S. Mill.

**John Stuart Mill.**—John Stuart Mill (1806–1873) began to write on economic subjects at an early age, and became one of the outstanding thinkers of the nineteenth century. As a boy, he was acquainted with Ricardo, who was an intimate friend of Mill's distinguished father, James Mill. Mill's notable work, *Principles of Political Economy*, published in 1848, went through many editions and was long used as a text in colleges and universities. This treatise contains Mill's principal work in the field of international trade, some of the material having been

previously published in his *Essays, on Some Unsettled Questions of Political Economy* (written in 1831; published in 1844).

Mill's work rests firmly upon the foundations laid by Ricardo, in fact much of it is merely a restatement of Ricardian doctrines. Mill began his analysis of international trade with a careful explanation of the principle of comparative costs. Goods are imported, he declared, because "it is cheaper to import than to produce them." But why is it cheaper to import them? When several commodities are produced in the same locality, he said, one is cheaper than another because it can be produced with less labor and capital—that is, at less real cost. This condition of lower real cost, however, is not necessarily the reason for the cheapness of imported goods. Imported goods frequently come from countries where costs in terms of effort and sacrifice are much greater than in the importing country. Such a situation persists because capital and labor do not flow freely from one country to another. A country with high real costs, wrote Mill,

would export articles of some sort, even to places which could make them with less labor than itself; because those countries, supposing them to have an advantage over it in all productions, would have a greater advantage in some things than in others, and would find it to their interest to import the articles in which their advantage was smallest, that they might employ more of their labor and capital on those in which it was greatest.<sup>6</sup>

Thus, in Mill's words, "it is not a difference in the *absolute* cost of production, which determines the interchange, but a difference in the *comparative* cost."<sup>7</sup>

Mill next proceeded to dispose in summary fashion of the fallacy that international trade is carried on in order to rid countries of their "surplus" goods. According to Mill, this error is a relic of mercantilist thought. Even Adam Smith, he pointed out, was not wholly free from it.<sup>8</sup> Mill wrote:

<sup>6</sup> *Principles of Political Economy*, 5th London ed., Bk. III, Ch. XVII.

<sup>7</sup> *Ibid.*, Book III, Ch. XVII.

<sup>8</sup> Thus Smith claimed that one of the "two distinct benefits" of international trade to the countries of the world is that "It carries out that surplus part of the produce of their land and labor for which there is no demand among them, and brings back in return for it something else for which there is a demand. It gives a value to their superfluities by exchanging them for something else. . . ." *Wealth of Nations*, Book IV, Ch. I.



The expression, surplus produce, seems to imply that a country is under some kind of a necessity of producing the corn or cloth which it exports; so that the portion which it does not itself consume, if not wanted and consumed elsewhere, would either be produced in sheer waste, or if it were not produced, the corresponding portion of capital would remain idle, and the mass of productions in the country would be diminished by so much. Either of these suppositions would be entirely erroneous. The country produces an exportable article in excess of its own wants, from no inherent necessity, but as the cheapest mode of supplying itself with other things.<sup>9</sup>

We now come to Mill's chief contribution to the theory of international trade: the principle of reciprocal demand, a statement of the principles which, according to Mill, establish the terms of trade. Ricardo, it will be recalled, had shown the conditions under which it would be profitable for countries to trade goods, but had not worked out a theory to explain the actual ratios at which goods are exchanged. Within the limits set by comparative costs (that is, within the limits which determine where it would be as cheap for countries to produce goods at home as to import them), there are innumerable ratios at which trade would be mutually profitable for the countries concerned. How are the existing ratios at which trade actually takes place established? This question Mill sought to answer.

In order to simplify the problem, Mill, like Ricardo, confined his analysis to situations involving two countries and two commodities. For the purpose of illustration, he chose England and Germany, and for commodities, broadcloth and linen. Suppose, said Mill, that before trade had been established between these two countries, in England 10 yards of broadcloth exchanged for 15 yards of linen, while in Germany the same amount of broadcloth exchanged for 20 yards of linen. In this case, it would pay England to exchange her cloth for German linen so long as she could get more than 15 yards of linen for her 10 of cloth. By the same token, it would pay Germany to trade her linen for English cloth if she could obtain 10 yards of cloth for anything *less* than 20 yards of linen. There exists, then, a wide margin within which trade between the two countries would be

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<sup>9</sup> *Principles of Political Economy*, Book III, Ch. XVII.

mutually advantageous. At a ratio of 10 yards of cloth for 19 yards of linen, most of the gain would go to England, though Germany would still profit by trade; at a ratio of 10 yards of cloth for 16 of linen, most of the gain would go to Germany, though England would still profit.

What is it, then, that determines (within the limits where trade is profitable) the actual ratios at which goods will be traded? The answer, said Mill, is *reciprocal demand*. If, in the above illustration, the demand of England for German linen were great, while the demand of Germany for English cloth were small, a ratio would be established in which most of the gain from trade would accrue to Germany (for example, a ratio of 16 yards of linen for 10 of cloth). If, on the other hand, German demand for cloth were great while English demand for linen were small, a ratio would be established in which England would secure most of the gain (for example, a ratio of 10 yards of cloth for 19 of linen).

Whatever ratio were established, a condition of equilibrium would be attained, Mill showed, only when the total value of the cloth which England exported equaled the total value of the linen which Germany exported (assuming, of course, that only two goods were traded). If the value of the German linen, for example, were greater, gold would tend to flow from England to Germany, which would tend to raise prices in Germany and lower them in England. This would tend to reduce exports of German linen and increase those of English cloth until the exports of each country exactly paid for the imports. This tendency toward equivalence Mill referred to as "the equation of international demand." In his words: "The produce of a country exchanges for the produce of other countries at such values as are required in order that the whole of her exports may exactly pay for the whole of her imports."<sup>10</sup>

Mill's theory of reciprocal demand has been criticized by a number of writers. Some of these criticisms we shall consider later; others are too involved for treatment within these pages. When all is said, however, Mill's work remains as having aided greatly in clarifying the intricate problems connected with the

<sup>10</sup> *Op. cit.*, Book III, Ch. XVIII.

theory of international values. Even though much of his reasoning involved fallacies, he provided more groundwork on which others could build.

**Refinements of the Classical Theory.**—We have discussed the chief doctrines in the theory of international trade developed by the English classical school. The major parts of this theory, as it existed after the publication of Mill's *Principles*, were, to sum up: (1) the principle of international specialization according to natural advantages, as presented by Adam Smith; (2) the monetary analysis developed by Hume and expanded by Ricardo, Mill, and others, dealing with the flow of specie and the effects upon price levels<sup>11</sup>; (3) the comparative-cost doctrine of Ricardo, as contrasted with the earlier and simpler statement of absolute advantage; and (4) the principle of reciprocal demand as stated by Mill to explain ratios of trade, and his closely related equation of international demand. We shall now consider various additions to, and refinements of, these so-called classical doctrines made by other British writers of the nineteenth and early twentieth centuries.

An important contribution to the understanding of international wage-level relationships was made by Nassau William Senior (1790–1864), a contemporary of Mill. Senior was concerned with the question of what determines the different levels of money-wage rates in the various countries of the world. He concluded that the level of money wages prevailing within a country is governed by the productivity of labor in that country's export industries relative to the productivity of labor in the same industries abroad. According to this doctrine, if labor in a country's export industries is more efficient, and therefore productive, than such labor in foreign countries, the level of money wages in the country will be higher than money-wage levels abroad; if, on the other hand, labor in a country's export industries is inefficient relative to such labor abroad, money wages in the country will be low.<sup>12</sup> On the basis of this reason-

<sup>11</sup> See Chapter 18.

<sup>12</sup> Senior interpreted efficiency of labor broadly to include efficiency resulting from "superior diligence," "superior skill," "assistance of a larger capital," "de-ferring for a longer time remuneration," or "any advantage natural or acquired." Senior, *Three Lectures on the Cost of Obtaining Money*, 1830.

ing, essentially sound as far as it goes, Senior attacked the notion that high money-wage rates are an obstacle to a country's foreign trade. Such a notion, he implied, reverses the true sequence of cause and effect. He wrote:

It is obvious that our power of competing with foreigners depends on the efficiency of our labor, and it has appeared that a high rate of wages is a necessary consequence of that efficiency. . . . To complain of our high wages is to complain that our labor is productive—to complain that our workpeople are diligent and skillful. To act on such complaints is as wise as to enact that all men should labor with only one hand, or stand idle four days in every week.<sup>13</sup>

The next great classical writer after Mill and Senior was the Irish economist, John Elliot Cairnes (1832–1875), who did much to polish off some of the rough edges of classical doctrine. Cairnes' work in the theory of international trade is found in his treatise, *Some Leading Principles of Political Economy*, published in 1874.

It will be recalled that in the analysis of Ricardo and Mill, the factors determining international values were considered to be entirely distinct from those determining values within a country. The prices of domestic goods were assumed, under the operation of free competition, to be determined by cost of production, while the prices of internationally traded goods were not explained by Ricardo, and in the analysis of Mill were assumed to be determined by reciprocal demand, operating within the limits set by comparative cost. Thus for international goods Mill leaned toward a demand-and-supply approach, whereas for most domestic goods (there were a few exceptions, such as non-reproducible goods) he regarded cost of production as the final answer to the question of price determination. Between the two types of price theory existed a wide gulf. Cairnes, by recognizing the existence within a country of "non-competing groups," carried domestic price reasoning part way toward a demand-and-supply concept. Cairnes, however, continued to emphasize cost of production as the price determinant within each group.

<sup>13</sup> Senior, *op. cit.*

Under free competition, said Cairnes, prices of goods are determined by cost of production. But free competition is the exception rather than the rule. Within every country are numerous non-competing groups of workers. Skilled workers do not compete directly with unskilled workers, professional men do not compete with artisans, doctors with lawyers, and so on. To the extent that free competition does not prevail within a country, it cannot be said that domestic prices, any more than international prices, are determined by cost of production. How, then, are such prices established? According to Cairnes, the prices of all goods produced under conditions other than free competition are determined by "reciprocal demand." He wrote:

As in international trade an increased demand for the products of other countries will, other things being equal, affect international values—or, let us say, affect the relative prices of the products of different countries—unfavorably for the country whose demand is increased; and as, again, the converse of this condition, an increased demand by other countries for the products of a given country, will operate in the contrary direction; so it will be in the exchanges which take place between non-competing groups. Whatever increases the demand of a given group for the products of outside, that is to say non-competing, industries, or (what comes to the same thing) whatever increases the supply of its products available for the purchase of the products of such industries, will, other things being the same, depress the prices of its products in relation to the prices of the products of the industries against which they are exchanged, and vice versa. . . .<sup>14</sup>

Nations, according to Cairnes, are merely large non-competing groups. In so far as free competition does not exist, the prices of domestic as well as of internationally traded goods are determined in essentially the same way, that is, by reciprocal demand.

Cairnes improved considerably upon Senior's statement of wage and price relationships in the theory of international trade. He declared that a country's money and real wage levels, and the character of its foreign trade, "are co-ordinate effects of a common cause, that cause being the degree and direction in

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<sup>14</sup> *Some Leading Principles of Political Economy*, p. 90.

which a nation's industry happens to be productive." <sup>15</sup> High real wages in a country, according to Cairnes, indicate that "high productiveness" prevails in many industries, that a country's labor is in general efficiently engaged. A high level of money wages, Cairnes held, indicates "either rich mines of gold or silver, or a high productiveness of industry in some commodities in large demand abroad with which gold or silver may be purchased on favorable terms." <sup>16</sup>

On the basis of the above reasoning, Cairnes, like Senior, attacked, as "absolutely without foundation," the notion that a high money-wage level makes a country unable to compete abroad and is incompatible with a thriving foreign trade. Such a notion, he maintained, completely confuses cause and effect. Far from being incompatible, high money wages and a large export trade are often found together, since both are evidences of efficient export industries.

Cairnes was the first classical writer to stress the importance of invisible items in a nation's balance of payments. He also discussed the manner in which the industrialization of a country may affect its balance of trade. He distinguished three stages in this evolution: (1) a borrowing period, tending to produce an unfavorable balance of trade for the borrowing country, (2) an intermediate period in which interest payments offset new capital imports, and (3) a period in which interest payments plus capital repayments exceed new loans, establishing a favorable trade balance. <sup>17</sup>

Further refinement of the classical doctrines was made by C. F. Bastable, an Irish economist, whose *Theory of International Trade* was published in 1893. This work is short—less than two hundred pages—but contains much that is new. Bastable tried to make the classical theory of trade more realistic. In his second chapter, entitled "The Theory of International Values," he proceeded to modify various of the rigorous and unreal assumptions underlying the analysis of Ricardo and Mill.

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<sup>15</sup> *Some Leading Principles of Political Economy*, p. 339.

<sup>16</sup> *Ibid.*, p. 340.

<sup>17</sup> *Ibid.*, pp. 359-363.

The first assumption he dealt with was that of constant costs. Ricardo and Mill in their studies had tacitly assumed that industry operates on a basis of constant costs (in which costs per unit of output do not change with a change in the rate of output). Under this assumption, an increase or decrease in the demand for a product would not result in any change in the cost of producing a unit of the product. But industry rarely operates on this principle. Either unit costs tend sooner or later to increase as demand increases, as, for example, sometimes in agriculture, or costs tend to decrease as demand increases, making possible expanded operations, as in much large-scale industry. Where costs are not constant, the limits set by comparative cost will vary with changes in the rate of output. Bastable's principal conclusion on this subject is "that the operation of the law of diminishing return [increasing costs] tends to limit the area of international exchange, while that of the law of increasing return [decreasing costs] is calculated to extend it."<sup>18</sup>

Following the example of Cairnes, Bastable disagreed with the assumption of perfect competition within each country. He also extended his analysis to include situations involving more than two countries and two commodities.

Two men whose original work in this field is significant, but on the whole too detailed for more than summary mention here are Alfred Marshall (1842-1924) and F. Y. Edgeworth (1845-1926). Marshall's studies on international trade appear in a privately printed volume, *The Pure Theory of Foreign Trade* (1879),<sup>19</sup> and in his last work, *Money, Credit, and Commerce*, published in 1923. Edgeworth's contributions are found in his *Papers Relating to Political Economy* (1925), a collection of previous articles and monographs. Both writers leaned heavily upon classical foundations. Both were skilled in diagrammatical and mathematical analysis, which they employed extensively. In order to avoid the unreality of situations involving only two commodities (as in the analyses of Ricardo and Mill), Marshall introduced a new theoretical concept: the "representative bale of goods," embodying a constant quantity

<sup>18</sup> *Theory of International Trade*, 4th ed., 1903, p. 31.

<sup>19</sup> Reprinted by the London School of Economics, 1930.

of a country's labor and capital. Thus the simple and unreal reasoning based on cloth versus linen, as though these were the only articles traded, was broadened in the endeavor to conform to actual conditions. By means of this tool, Marshall attempted a more generalized exposition of the theory of international trade, though his conclusions based on this method, as well as the method itself, have not met with unanimous assent. Edgeworth devoted himself to a variety of isolated problems in theory. Among his contributions is an elaborate theoretical analysis of the gain from trade.



## CHAPTER 17

### CONTEMPORARY INTERNATIONAL TRADE THEORY

At the present time, two leading schools of international-trade theory can be distinguished. On the one hand is the modern classical school, which upholds in modified form the doctrines of Ricardo and Mill, while on the other hand is the so-called general-equilibrium school, which takes an entirely different approach to the problem. There are a large number of theorists who would not care to be classed as members of either group, but in most cases their thinking follows largely that of one or the other. The two lines of thought, as will be seen, lead to basic conclusions not so far apart as might at first appear.

**The Modern Classical Position.**—Many modern international-trade theorists, particularly in England and America, have built upon the foundations laid by Ricardo and Mill. Their theoretical analysis may thus be termed modern classical, or neoclassical.

Modern classical economists begin with an analysis of costs of production as the basis for domestic exchange value. Prices within a country are assumed to reflect, at least approximately, real costs within that country. An article priced twice as high as another is thus assumed to have been produced at twice the cost of the other, costs referring to real costs (disutility). Any discrepancies or irregularities which may exist in the relation of costs to selling prices, ordinarily, it is held, tend to disappear under the influence of free competition. If the price of an article becomes high in comparison to its costs, competition of producers and sellers, it is said, will force the price down, and vice versa.

Classical writers have differed in their interpretation of real costs. Many theorists, following the example of Ricardo, have adhered to a labor-cost analysis, holding, as noted, that domestic exchange values of goods correspond with reasonable accuracy to the relative amounts of labor involved in the goods' production, using labor as representative of general real costs. Others, following Cairnes, have attempted greater realism by taking into account such types of real cost, or disutility, as abstinence and sacrifice. In either case, the foundation is laid for the doctrine of comparative costs.

This doctrine of comparative costs, so important in classical analysis, is used to explain why countries find it to their advantage to specialize in the production of certain commodities while importing others. A country, it is held, exports those commodities in the production of which its comparative real costs are lowest. Comparative costs are a reflection of comparative advantages. The doctrine thus builds on the principle of comparative advantage. Comparative costs are merely a measure of comparative advantages, or disadvantages, stated in terms of costs, i.e., real costs.

As pointed out in the preceding chapter, the doctrine of comparative costs does not provide an explanation of the precise terms at which goods exchange between countries. It endeavors to show the reasons for specialization and why nations produce certain goods, but does not deal with the terms of trade. To explain these ratios or terms of trade, the concept of reciprocal demand is introduced, according to which a nation with a strong demand for foreign goods is ordinarily in a weak or unfavorable position regarding the terms of trade, and vice versa. The exact terms are the result, it is held, of the interaction and relative strength of the demands, just as they are in any trade. The theory of reciprocal demand has been analyzed in detail by certain writers, much attention being given to elasticity of demand and related matters.

We have already seen how classical doctrines were refined and extended by British theorists of the later nineteenth and early twentieth centuries. Important in this process of elaboration were Cairnes' treatment of non-competing groups, and

Bastable's refinements, such as his analysis of the effect on trade of production under conditions of varying cost; also important were the theoretical contributions of Marshall and Edgeworth. Modern classical theorists have pursued, in general, the same fundamental lines, endeavoring to meet situations wherein the theory did not conform to real life.

A leading representative of the classical tradition is the late F. W. Taussig, for many years professor of economics at Harvard University. Professor Taussig dealt not only with the theoretical aspects of international trade, but made extensive factual studies. His published works in this field include *The Tariff History of the United States* (1888), *Some Phases of the Tariff Question* (1915), *Free Trade, the Tariff, and Reciprocity* (1919), and *International Trade* (1927).

Taussig is noteworthy for the thoroughness of his analysis. His treatment of comparative costs, world wage and price levels, non-competing groups, capital and interest, varying costs, and other topics employs numerous arithmetical illustrations which is in contrast to the vagueness and obscurity often found in earlier writers. Moreover, his extensive use of descriptive and statistical material gives his work reality in a subject which can easily become remote from the problems of the real world.

Taussig builds his analysis of comparative costs upon a modified labor-cost theory of value. Ricardo, it will be recalled, held that comparative costs are actually comparative labor costs. Within each country, he maintained, domestically produced goods will tend, under the influence of free competition, to be priced in proportion to the relative amounts of labor time involved in their production. Taussig was of course aware of the objections to a labor theory of value, but held that these criticisms did not prevent the doctrine from being a useful approximation so far as the theory of international trade is concerned.

In support of his labor-cost approach, Taussig resolves all money costs of production into two and only two items, wages and interest. Expense for raw materials, he holds, can be broken down into previous expense for wages and interest, and therefore should not be considered separately as a cost of production. Similarly, the cost of tools consists of payment for labor which

made the tools, plus interest. Rent, he says, is not to be considered a cost of production; it is rather a result than a cause of cost. Rent, in Taussig's words, is "merely a differential element"; for example, in the case of land, rent measures the difference between productive as opposed to less productive land. Rent "stands for the differences in the expenses of production and serves to equalize them."<sup>1</sup>

Taussig then attempts to show that over a wide range of cases, the introduction of interest expense in no way affects a country's comparative-cost situation or the course of international trade. He supports his case with a number of arithmetical examples, but his major conclusions may be quoted in a few words. He writes that

interest on capital acts on international trade not in itself, but only in so far as it operates differently on different commodities. At the very start it is obvious that an interest charge, added uniformly to the expenses of production, brings no alteration in relative prices, since it acts equally on all commodities. Nor does an interest charge have an effect simply because it is at a different rate in the two countries—higher in one than in the other. If within each it acts uniformly throughout, it leaves the relations between the countries undisturbed. Further: an interest charge does not alter the conditions for trade, even though it act on one commodity only, provided it acts on that commodity in the same way in both countries. The same is true . . . if the interest charge, instead of being absent on one article while present on another, is merely greater on one than on another. If the difference is the same in both countries, international trade goes on in the same way as if this factor had not entered.<sup>2</sup>

Following this train of thought, which emphasizes labor costs, Taussig gives considerable attention to the effectiveness of labor and to wage levels, which vary from country to country. He discusses both money wages and real wages, as well as price level relationships. His work in this area is largely a refinement of the doctrines of Senior and Cairnes.

In stating the theory of comparative costs he points out that a country exports those goods which are low in price (cost)

<sup>1</sup> Taussig, *International Trade*, 1927, New York, The Macmillan Co., p. 62.

<sup>2</sup> *Op. cit.*, pp. 65-66.

within its borders (relative to prices of the same goods abroad), and imports goods which would be high in price (relative to prices of the same goods abroad) if domestically produced. Those goods which can be most cheaply produced, and hence exported, tend to be the ones, according to Taussig, in which a country's labor is applied most effectively. The money wages paid by the export industries will be high or low, compared to other countries, Taussig holds, according to the effectiveness of this labor relative to that of other countries. Money wages in export industries will be high if the effectiveness of labor there is great, low if the effectiveness of labor is not great. In either case, however, the level of wages paid by the export industries will tend to set the pace for wages in the other industries within a country. If domestic industries are to get efficient workers, they must meet the wage rates prevailing in the export industries which tend to get the most efficient workers.

Whether real wages, as opposed to money wages, will be high or low will depend, according to Taussig, upon the general effectiveness of a country's labor as a whole. If labor is highly productive not only in export industries but in domestic industries as well, prices as a whole will be low relative to other countries (since a large amount of goods are produced), and real wages will therefore be high (because of the effectiveness of workers and consequent high money wages). If labor in domestic industries, however, is not very productive, prices of domestic goods will tend to be high (goods scarce), so that despite high money wages (because of efficient export industries), real wages may be low.

Taussig holds that wages and prices within a country tend to move together, a rise in a country's price level being generally accompanied by a corresponding rise in its money-wage level, and a fall in the price level by a fall in the wage level. He emphasizes, however, that high wages do not necessarily mean high prices in general, nor do low wages mean a low price level in general, despite the popular impression to this effect. A high (or a low) money-wage level may exist with either a high or a low price level. Taussig holds that the actual situation in any particular country will depend, as we have just seen, upon the

relative effectiveness of the country's labor as a whole, in both domestic and export industries, as compared with the relative effectiveness of labor abroad.

Taussig asserts that money wages and incomes are an index of a country's terms of trade. High money wages and incomes in a country, relative to money incomes abroad, are, he says, an indication of favorable terms of trade for such a country, since prices of internationally traded goods (barring costs of transportation) are the same the world over, so that high money incomes are an advantage in buying international goods. Low money wages and incomes, on the other hand, indicate unfavorable terms of trade, since a nation with low money incomes is at a disadvantage in buying in the world market.<sup>3</sup>

Taussig says that a country reduces its benefits from trade by erecting tariff barriers against the importation of goods. The benefits from trade being indicated by the relation between money incomes and the prices of imported commodities (the higher the money incomes and the lower the prices of imported commodities, the greater the gain), it becomes obvious that a rise in the prices of imported commodities induced by a protective policy reduces or completely eliminates the gain from trade.

Lack of space prevents a detailed discussion of other modern classical theorists, although mention should be made of Jacob Viner, whose work has been along classical lines.<sup>4</sup> Viner was a pupil of Taussig, and his work reveals the influence of his teacher. Viner's most significant contributions to this field are found in his *Studies in the Theory of International Trade*, published in 1937. This work contains, in addition to considerable historical material, a detailed examination of the modern exchange mechanism and the theory of international values. Viner gives a critical analysis of the doctrine of comparative costs and the problem of gain from trade. His theoretical work does not lend itself well to summary discussion, but is commended, to those who wish to investigate these matters further, as the most

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<sup>3</sup> Taussig fails to recognize that general physical productivity is more important than the terms of trade, and that this overshadows even unfavorable terms. Furthermore, high wages and incomes in general cannot be said to cause favorable terms.

<sup>4</sup> British neoclassical writers were discussed in the preceding chapter.

acute general treatment of the history of international-trade theory yet made.

**Criticism of Classical Theory.**—The classical approach to international-trade theory, like that to domestic value theory, has throughout its history been the target of severe attack. Much of the criticism has been directed at the inadequately analyzed assumptions underlying the classical doctrines, such as the assumptions of perfect competition within each country, of complete immobility of labor and capital between countries, but mobility domestically, and of constant costs. Later classical writers, of course, relaxed some of the Ricardian assumptions, particularly those just mentioned.

The basic objection to classical theory, however, has not been so easily overcome. Ricardo's analysis of international trade, like that of his successors, is built upon the labor theory of value. Domestic values (exchange values), according to Ricardo, are determined by labor costs; international values, by comparative labor costs. Economists have long since discarded the labor-cost theory of pricing, pointing out that goods do not exchange on the basis of labor costs or, for that matter, on the basis of any other kind of costs. The price relationship of goods is very different from the relative amounts of labor required to produce them and not infrequently from their monetary costs of production. The problem must be approached at the other end, namely, on the basis of demand and supply.

The labor theory of value necessarily assumes perfect competition both in the labor market and in the market for commodities, whereas, actually, free competition does not prevail in either area, except perhaps in a few rare instances. Economic life in industrial nations is largely organized on a monopolistic or semi-monopolistic basis; it is characterized by huge corporate productive units, large chain distributing agencies, labor unions, employer associations, and other well-established institutions together with a high degree of governmental control and subsidy, so that such competition as exists is ordinarily far from perfect. Labor and capital, moreover, are relatively immobile and do not move quickly to the best market, which is necessary if com-

petition is to perform its equalizing function and keep prices in strict harmony with costs. Furthermore, many goods and services are unique or are approximately unique, so that there can be no perfect competition for them.

The labor theory of value, moreover, assumes that labor is a homogeneous factor of production, that an hour's labor, for example, is something definite and uniform. This assumption is obviously unrealistic. Labor is made up of many different qualities and grades, efficient and inefficient, skilled and unskilled, which receive different rates of pay and which, to all intents, are separate factors of production.

Furthermore, the labor theory of value assumes that all money costs of production other than wages either can be identified as previous wages or, if this is not possible, as in the case of interest, can be found combined with wages in approximately the same proportion, so that relative prices are not affected by the varying degree to which costs other than wages are a part of total costs. If all money costs are resolved into wages and interest, for example, it must then be assumed either that interest expense is generally so small as to be inconsequential, or that it is always combined with wage expense in approximately the same proportion. Otherwise, relative prices will be significantly affected by the extent to which interest enters into costs, with the result that the labor theory of value will not give even an approximate explanation of domestic price relationships. The assumptions made do not conform to the facts. The most superficial survey of modern industry reveals that interest expense is often large and that products vary widely in the proportions in which labor and capital are combined in their production.<sup>5</sup>

The labor theory of value looks largely to supply and to the forces determining supply. Here it offers an inadequate explanation of what determines supply, namely, that costs of production determine supply, and that such costs are labor costs.

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<sup>5</sup> Taussig argues, as noted above, that if the rate of interest is different in two countries, but within each country acts uniformly on all costs, it can be disregarded from the standpoint of its effect upon foreign trade. This overlooks the fact that if costs within a country are raised because of higher interest rates—even though the rates apply uniformly to all costs so that domestic price relationships remain unchanged—this higher cost situation would react unfavorably upon such a country's total exports and therefore upon its terms of trade.



It, in general, assumes price as a predetermined and established fact, and reasons that supply is the amount that can be produced at a cost sufficiently low to meet the given price. Modern value theory on the other hand shifts emphasis from supply, stressing the mutual interdependence of demand, supply, and price. Price is recognized as itself determined, or influenced, by supply and also by demand. These forces are all in equilibrium each affecting the others.

The above considerations are enough to explain why the labor theory of value has been generally abandoned by economists. With reference to the doctrine of comparative costs, in addition to its being based on the labor-cost-price analysis, another main weakness is that trade between countries does not, as the doctrine assumes, take place because of differences in costs, either real costs or even monetary costs. Importers are not interested in the costs of goods, but in the prices they must pay. It is the ratios between prices of goods (or money costs, if we were to allow a rigid relationship or identity between money costs and prices, which, however, does not exist) that determine whether trade is profitable. If prices of goods in one country hold the same relationship to each other as prices in another country, no basis for permanent trade exists. For example, if 10 yards of cloth exchange for 20 bushels of wheat in both countries, no reason for trade between the countries is present, regardless of the comparative costs in the two countries.

The classical theory of international trade grew up in the storm-center of controversy over free trade versus protection, and has always been intimately connected with discussions of trade policy. This helps to explain its preoccupation with such concepts as "gain from trade" and "terms of trade." It is impossible to discuss intelligently the problem of gain from trade without introducing the idea of "real cost," or "effort cost," since the gain from trade is essentially the increase, in terms of effort, of the amount of goods and services secured by trade over the amount which could be obtained without trade. The labor theory of value facilitated analysis along these lines.

Various theorists, such as Taussig, have held that even if this value doctrine is only a rough approximation to reality, it is a

useful and legitimate analytical tool. Equilibrium theorists, however, declare it misleading, inaccurate, and the source of confusion. It does not explain that which it pretends to explain, therefore should be discarded and attention directed to a correct explanation. Attempting to patch up a theory which is invalid serves no useful purpose, except, perhaps, satisfying the reluctance to abandon something with a long and prominent history.

Not all classical writers have employed a labor theory of value in their analysis of international trade. For example, Cairnes, in his treatment of comparative cost, wrote in terms not of labor costs but of "human" costs, of which he distinguished two: labor and abstinence. Bastable developed his analysis in terms of "units of productive power." These attempts at greater realism, however, did not get at the root of the trouble. As various critics have shown, this type of approach tries to add together quantities which are incommensurable. Labor and abstinence are both real costs, but they have no common denominator. There is no logical way of stating how many hours of abstinence are equal in disutility to, for example, 10 hours of a certain kind of labor. These costs can no more be added together than can yards and bushels.

While not susceptible of accurate measurement, the concept of real costs, like that of real wages and psychic income, has usefulness, particularly from the standpoint of welfare economics. It does not, however, get us very far in explaining and stating precisely the underlying forces and mechanism of international trade, and can easily lead to confused thinking.

One feature of the classical approach—the two-country, two-commodity assumption—has been sharply criticized in recent years by Frank D. Graham. Professor Graham holds that the typical classical procedure of generalizing from situations involving only two countries and two commodities is misleading, yielding "wholly unwarranted inferences."<sup>6</sup> He is particularly critical of Mill's analysis and conclusions. Mill, it will be recalled, concluded that where there are two countries and

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<sup>6</sup> Graham, "The Theory of International Values Re-examined," *Quarterly Journal of Economics*, November, 1923, p. 55. Further criticism along these lines will be found in Graham's later article, "The Theory of International Values," *Quarterly Journal of Economics*, August, 1932, pp. 581-616.

two commodities, the play of reciprocal demand will tend to set the ratio at which the two products are exchanged somewhere between the extreme limits of the range wherein trade is possible, the limits set by comparative cost (that is, between the limits where it would be as cheap for each of the countries to produce the other's specialty as to import it). He held that it was conceivable, but not probable, that the play of demand might set the ratio of exchange at either of these limits, so that all the gain from trade would go to one of the countries and none whatever to the other.

Graham, on the contrary, holds that on the basis of Mill's assumptions, the ratio of exchange will ordinarily rest at one of the extreme limits and only in exceptional cases will it be somewhere between. Only in instances where the two countries are of approximately equal economic importance and the two commodities of approximately equal "total consumption value" will the ratio of exchange, according to Graham, tend to settle between the possible limits and thus divide the gain from trade between the two countries. Graham's reasoning is as follows. In Mill's illustration, it will be recalled that before specialization and trade, 10 yards of broadcloth could be produced in England at the same cost as (and hence exchanged for) 15 yards of linen; while in Germany 10 yards of broadcloth could be produced at the same cost as (and hence exchanged for) 20 yards of linen. England's specialty was thus cloth, and Germany's linen. Assuming perfect competition, as Mill did, linen would continue to be produced in England so long as English linen producers received the equivalent of at least 10 yards of cloth for their 15 yards of linen. If the price of linen declined (because of importations from Germany) so that they received only 9 yards of cloth for their 15 of linen, they would shift to the production of cloth, since they would thus receive 10 yards of cloth for the same effort required to produce 15 yards of linen for which they could now get only 9 yards of cloth. There would, however, be no advantage in shifting away from linen (Germany's specialty) to the production of cloth so long as they received at least 10 yards of cloth for their 15 of linen. Similarly, cloth (England's specialty) would continue to be produced in Ger-

many so long as German cloth producers received the equivalent of not less than 20 yards of linen for their 10 yards of cloth. If cloth declined and they received only 19 yards of linen for their cloth, they would shift to linen. Under any ratio between 15 and 20 yards of linen for 10 yards of cloth, according to Mill, English linen producers would shift to the production of cloth and German cloth producers to the production of linen until England had completely specialized in the production of cloth and Germany in the production of linen.

But suppose, says Graham, that we modify Mill's illustration by substituting for Germany a much smaller country, say Denmark, and assume at the same time that broadcloth and linen are products of approximately equal "total consumption value"—that is, that the total value of the production of each article is about equal.<sup>7</sup> What would happen in this event after trade is opened is clearly stated in Graham's own words:

... paraphrasing exactly Mill's assumptions, with the substitution of Denmark for Germany, let us suppose that trade is initiated at the exchange rate of 10 yards of cloth for 17 of linen. Such a trade must cause a rapid shifting of English production from linen to cloth, and of Danish production from cloth to linen, and, under the assumed conditions, nothing can stop this shifting until it has completely eliminated either the Danish production of cloth or the English production of linen. Since we are supposing that the total value of linen and cloth is in approximate equality, Denmark, as the smaller country, will be completely specialized in linen production while there are, perhaps, nine tenths of the English linen producers still left in that business, the specialization by the Danes being sufficient to drive only one tenth of the English linen producers into the making of cloth. In these circumstances the terms of interchange of cloth for linen must move to the extreme most favorable to Denmark, that is to say, 10 cloth for 15 linen; for a supply of linen adequate to the English demand is not obtainable on any better terms, the terms which the English linen producers require if they are to continue their operations.<sup>8</sup>

<sup>7</sup> Graham does not explain how the values in a country are to be compared or combined with the values in the other country. If a monetary unit is used, this unit must be in terms of the rate of exchange between the two countries which is itself influenced by the trade which is being explained.

The answer, in which Graham concurs, is that in every situation involving interaction it is impossible to start from a fixed base. Each force influences the others, and if we are to analyze the situation we must break in somewhere.

<sup>8</sup> "The Theory of International Values Re-examined," *loc. cit.*, pp. 57-58.

If the terms, in order to give some of the gain to England, were only 9 of cloth for 15 of linen, none of the English linen producers would find it profitable to produce linen since 15 of linen required the same amount of work as 10 of cloth. It would be easier to get 15 of linen by producing 9 of cloth. They would therefore continue to shift to cloth until 10 of cloth traded for 15 of linen.

Thus two results follow from the substitution of a smaller country: (1) the entire gain from trade goes to the smaller country, the larger one being no better off than before trade, and (2) the larger country continues to produce both commodities after trade is opened. Denmark secures its entire cloth supply by trading linen for it; England produces a part of its consumption of linen and imports the rest in exchange for cloth.

Graham shows that similar conclusions follow if, instead of substituting a small country for a large country, a commodity of small total consumption, for example, matches, is substituted for one of the commodities in Mill's illustration. Let us, then, substitute matches for linen, and assume that before trade, 10 yards of cloth exchange for 15 crates of matches in England and for 20 crates in Germany. If trade is opened on the basis of 10 yards of cloth for 17 crates of matches, English producers of matches will quickly leave the business and turn to the more profitable business of producing cloth to trade for matches. But since we are assuming that the total consumption value of matches continues to remain smaller than that of cloth, Germany will never be able to find in England a market for matches large enough to pay for her whole consumption of cloth. Hence Germans must continue to produce cloth at home, and German producers will find it profitable to do so only at the old ratio of 10 yards of cloth for 20 crates of matches. At this ratio, however, the entire gain from trade goes to England.

Thus Graham concludes that in virtually all trading situations involving only two countries and two commodities, the terms of interchange will settle at one of the two extremes, so that the whole gain from trade will go to one of the countries, the other country being no better off than before trade. The result can be otherwise, Graham holds, only where "the dice are

loaded by assuming trade in two commodities of approximately equal total consumption value and between two countries of approximately equal economic importance.”<sup>9</sup>

Trade, however, is not merely between two countries. If Germany cannot find a large enough market for matches in England to pay for Germany's whole consumption of cloth, she might, for example, send matches to Portugal and let Portugal send wine to England. It can be seen that the entire world market is involved, not only for matches but for all commodities and for all countries. If Mill's conclusions, even on the basis of his own simple assumptions, are misleading, they are far more inadequate, Graham maintains, as generalizations applying to the real world.

Mill's two-country, two-commodity procedure, Graham points out, conceals the fact that comparative advantage in realistic situations varies according to the terms at which products are exchanged. For example, if the foreign demand from all sources for a certain article declines (or if the supply of it increases), so that this article trades for fewer foreign goods, a nation producing the article might find that it no longer had an advantage in its production. The nation might have been a marginal producer of the article, and because of the reduction in demand (or increase in supply), become a sub-marginal producer. On the other hand, an increase in the demand for a commodity (or a decrease in the supply) would tend to produce opposite results.

Mill's illustrations, says Graham, give the impression that the terms of interchange are determined by reciprocal demand on the basis of a *fixed* comparative-advantage situation for each country. A change in the terms of interchange, however, will tend to alter the comparative-advantage situation of one or more countries. A slight change in these terms, which is reflected in a change in price, may make it profitable for a country to produce a commodity which it formerly only imported, or to export a commodity which it formerly produced only for home consumption, or to import a commodity which it formerly produced at home, and so on. Thus to reason about reciprocal demand

<sup>9</sup> "The Theory of International Values Re-examined," *loc. cit.*, p. 59.

and terms of interchange as if import and export schedules for the various countries were fixed is a mistake. Yet this, Graham maintains, is precisely what the classical writers did, on the basis of oversimplified assumptions, with the result that they implicitly assumed the very ratio of interchange they were trying to discover.

On the positive side, Graham shows how the terms of trade are actually established, and, under given assumptions, what the exact terms would be. His analysis thus gives a precision to the terms of trade which is lacking in the classical analysis, and also in that represented by Ohlin. The latter analysis sums up to the statement, in effect, that the terms of trade are the result of many complex conditions which are as they are because that is the way they are constituted.

**The General-Equilibrium Theory.**—In contrast to the classical theory of international trade is what is commonly referred to as the “general-equilibrium” theory. Widely accepted in recent years, this is an attempt to restate the theory of international trade in terms of modern value theory. It is essentially the application of domestic value theory to foreign trade—the remedying of an illogical distinction made by classical economics. The problem is attacked from the standpoint of demand and supply rather than by starting with cost of production and then building up to price. While the classical and general-equilibrium approaches start at different ends, the theories as a whole and their conclusions are not as far apart as might at first appear. Much of the difference is a matter of emphasis.

Equilibrium reasoning is not new as an explanation of value, domestic and foreign, yet its widespread acceptance as applied to foreign trade has been a recent and tardy development.<sup>10</sup> Bertil Ohlin, of Sweden, has done much to promote a wider understanding of equilibrium reasoning as applied to the international field. Ohlin’s analysis is set forth in his work, *Inter-regional and International Trade*, published in 1933, and is a comprehensive statement of the equilibrium position. In the

<sup>10</sup> Pioneer work in general equilibrium analysis was done by Leon Walras (1834–1910), Vilfredo Pareto, Knut Wicksell, Gustav Cassel, and Frank A. Fetter.

preface to this treatise, Ohlin declares that he has attempted to construct "a theory of international trade in harmony with the mutual-interdependence theory of pricing—the universally accepted price theory today—and thus independent of the classical labor theory of value."<sup>11</sup> The title of Ohlin's work emphasized the fact that the theory of international trade is to be developed in essentially the same way as the theory of trade between regions. This is in contrast to the classical outlook, which emphasized the differences between intranational and international trade.

Following orthodox equilibrium analysis, Ohlin begins by pointing out that regions and nations specialize and trade with one another for the same reasons that individuals specialize and trade. Certain persons are naturally best fitted for certain occupations. By temperament and abilities (native or acquired), one man becomes a gardener, another a teacher, a third a lawyer, and so on. The gardener would probably make a poor lawyer, and the lawyer might make a poor teacher; the gain from specialization, in any event, is clear. Even if every individual were exactly alike in ability and temperament, it would still pay to specialize. By so doing, each person would acquire a degree of skill not otherwise attainable, and would avoid the loss of time involved in shifting from one occupation to another.

Much the same reasoning can be applied to nations. One nation has a large amount of fertile land, no minerals, and a small population. Another has iron and coal mines, a large population, and little land. The former country would probably be well adapted to agriculture, the latter to manufacturing. In either case, the fields of superiority depend upon the extent to which the different factors of production occur in each country. It is, of course, not the possession of absolutely superior facilities which is the significant and determining condition; it is, rather, a question of which facilities are relatively the best. In the words of Ohlin:

Australia has more agricultural land, but less labor, capital, and mines than Great Britain; consequently Australia is better adapted to

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<sup>11</sup> Cambridge, Harvard University Press, p. vii.



the production of goods which require great quantities of agricultural land, whereas Great Britain has an advantage in the production of goods requiring considerable quantities of other factors. If both countries produced their own total consumption, agricultural products would be very cheap in Australia, but manufactured articles relatively dear, whereas the reverse would be the case in Great Britain. . . .

In brief, each region is best equipped to produce the goods which require large proportions of the factors relatively abundant there; it is, on the other hand, least fit to produce goods requiring large proportions of factors existing within its borders in small quantities or not at all.<sup>12</sup>

Having made these general observations, Ohlin proceeds to introduce money and prices. He first points out that it is impossible for one region or country to produce all commodities more cheaply than all other regions or countries. He illustrates this point as follows: Suppose there are two countries, *A* and *B*, each having a paper currency, and that at the prevailing exchange rate all prices in *A* are lower than the corresponding prices in *B*. In this case, people in *B* would buy goods from *A*, where low prices prevail, but no people in *A* would buy goods from *B* which has high prices. But with goods flowing in one direction only, that is, from *A* to *B*, the exchange rate could not remain stable. The currency of *A* would be much in demand in *B*, while the currency of *B* would not be at all in demand in *A*. At the same time, there would be no supply of *A*'s currency in *B*, since no one in *B* would have the right to draw a draft on anyone in *A*. In this situation, importers in *B* would bid up the exchange rate on *A* until some prices in *A* were higher to persons in *B* than the corresponding prices in *B*, making it possible for goods to flow in both directions. Equilibrium would be attained when the exports of each country exactly paid for the imports.<sup>13</sup>

In only one situation, Ohlin shows, could the result be otherwise. This is where relative prices in the two countries are the

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<sup>12</sup> *Op. cit.*, p. 12.

<sup>13</sup> Under a gold standard, equilibrium would be attained by a slower process. The exchange rate on *A* could rise only to the gold-export point of *B*, after which gold would flow from *B* to *A*, raising prices and incomes in *A* and lowering them in *B* until an equal value of goods moved in both directions.

same, in which case no trade at all would take place. To illustrate: suppose that in *A* three commodities—wheat, cotton, and lumber—are produced, and that the price of a given quantity of wheat is, say, twice that of a given quantity of cotton and one-third that of a given quantity of lumber. Suppose also that *B* produces the same commodities (of the same quality), and that the prices of these goods bear exactly the same relationship to one another as the prices in *A*. Finally, assume as in the preceding illustration that all prices in *A* are lower than the corresponding prices in *B*. This is, of course, an unstable situation. For a time, the three commodities would flow from *A* to *B*. The exchange rate on *A* would be bid up, as noted above, but when prices in *A* equaled those in *B* (allowing for cost of transportation) all movement of goods would cease, since neither country would have a price advantage over the other in any commodity, the prices being in the same relationship in both countries, and after the shift in price levels, the prices themselves being the same in both countries. Hence, for there to be trade between countries, relative prices in each must differ.

Having attributed the existence of trade to differences in relative prices between regions or countries, Ohlin next discusses the factors determining relative prices within a single region or country. Prices are determined, Ohlin declares, by "the demand for goods and the possibilities of producing them"—that is, by demand and supply. But what lies back of demand and supply? Demand, says Ohlin, is conditioned by two circumstances: (1) "the wants and desires of consumers," and (2) "the conditions of ownership of the factors of production, which affect individual incomes and demand." This refers to the distribution of purchasing power in the hands of consumers to back up the "wants and desires" referred to in (1). Supply, he declares, is also governed by two conditions: (1) "the supply of productive factors," such as natural resources, labor supply, etc., and (2) "the physical conditions of production," which are uniform throughout all countries.

In each region, then [he writes], we have a price mechanism, resting on these four basic elements, which determines simultaneously the prices of commodities and of industrial agents [factors of pro-

duction]. The question is evidently under what conditions these elements have a relation to one another, such that relative commodity prices coincide in two isolated regions, in which case no trade can arise. When the relation between them is different, relative commodity prices are also different, and interregional [and international] trade will come into existence.<sup>14</sup>

Of these four factors governing demand and supply, Ohlin lays greatest stress on "the supply of productive factors," which he regards as chiefly responsible for relative prices in one country being different from those in other countries. He admits that it is theoretically possible for demand to offset, or more than offset, the distribution of productive factors in a region or country, so that, for example, a region with a large supply of a certain factor might find that factor in strong demand and thus relatively scarce. He points out, however, that such a situation is improbable.

There is no reason [he asserts] why demand in a scantily populated region should turn especially to goods requiring much land and little labor, say wheat, and thus prevent rent from being lower, relatively to wages, than in a densely populated region, where, as people cannot after all do without food, land is necessarily scarce.<sup>15</sup>

In contrast to the classical writers, Ohlin devotes much space to a discussion of the effect on international trade of movements of the factors of production from one region or nation to another. He points out that "factor movements" tend to be an alternative to the movement of goods. When labor and capital move to areas where the reward for their services is higher, wages and interest tend to become equalized in the two regions. This has the effect of tending to equalize the prices of the goods produced by these factors in the two regions, which in turn tends to reduce the volume of goods traded. Thus factor movements, he declares, "act as a substitute for the movement of commodities."<sup>16</sup>

Another writer who follows the equilibrium approach is Gottfried von Haberler, whose *Theory of International Trade* was

<sup>14</sup> *Op. cit.*, pp. 14-15.

<sup>15</sup> *Op. cit.*, p. 16.

<sup>16</sup> *Op. cit.*

published in 1933. Like Ohlin, Haberler aims "to display the theory of international trade as a constituent part of the modern doctrine of economic equilibrium." Consequently, he rejects the classical labor theory of value. In this connection, he writes:

This latter doctrine [the labor theory of value] holds good . . . if there is only one factor of production: homogeneous labor. But in reality any country has a great number of different factors of production—a whole range of different qualities of labor, of land and other natural resources, and of produced means of production, such as buildings, plant and equipment, and raw materials. It is technically impossible to measure all these diverse factors of production in terms of any one common unit of quantity; they certainly cannot all be resolved into simple unskilled labor.<sup>17</sup>

The "sole purpose" of the labor theory of value, Haberler declares, was "to determine the relative prices in each of the two countries [in the classical illustration]." <sup>18</sup> But since relative prices can be explained more adequately by general-equilibrium theory, the labor theory, he says, is no longer needed.

In the preface to his book, Haberler expresses the conviction that an important task, as yet hardly more than begun, is the application of the theory of the business cycle and the theory of imperfect competition to the problems of international trade.<sup>19</sup>

**Conclusion.**—In conclusion, according to the equilibrium theory, trade takes place between regions or countries primarily because of differences in productive facilities and conditions. These differences, in conjunction with variations in demand, lead to different commodity prices, or more precisely, to different commodity price relationships in the various countries. Because of different commodity price relationships, certain goods can be obtained more cheaply abroad than at home. Commodity price relationships are based largely on the price relationships of the factors of production. If the factors of production were free to move from country to country, their movement would tend to

<sup>17</sup> *The Theory of International Trade* (English ed.), p. 175.

<sup>18</sup> *Ibid.*

<sup>19</sup> A good statement of modern international-trade theory as well as a discussion of classical doctrine is found in P. T. Ellsworth, *International Economics*, New York, The Macmillan Co., 1938.

reduce price differences of the factors and of the commodities.

When trade takes place, that which is given automatically equals in value that which is received. The ratios at which goods trade, that is, the terms of trade, are an outgrowth of demand and supply forces, namely, of the extent and strength of demand on both sides, i.e., reciprocal demand. Demand is to be measured in terms of that which is offered, which is supply and is also buying power. That which is offered is based on desires plus the difficulties of production. If goods are hard to produce few will be produced unless desires for them or what they will buy are very strong.

Exchange rates between currencies reflect reciprocal demand, and tend to settle at a point where value equivalence is established between what is given and what is received. The quantities given and received represent the terms of trade. An equilibrium rate of exchange is thus one that equilibrates, and in a nutshell this is about all that can be said.

The modern classical reasoning comes to practically these same conclusions, but arrives there by devious routes, making unreal assumptions and then endeavoring to explain away the difficulties, and making qualifications so as to fit the facts. The equilibrium theory recognizes not only cost as a determinant of price, but price as in turn a determinant of cost, whereas the classical theory emphasized the former sequence of causation, namely, that of cost to price, counting on free competition and demand and supply forces to bring prices into harmony with costs. Equilibrium theory says that this reasoning is incorrect in that demand is equally significant with supply, and also that free competition is an unreal assumption.

Classical theory recognizes that, particularly in international trade, free competition and perfect mobility of productive factors do not exist, and therefore in the international field emphasizes cost differences (and consequently price differences), as the driving force behind trade, identifying, as mentioned above, costs closely with prices. Equilibrium theory, on the other hand, emphasizes price differences, pointing out how prices are not absolute facts determined independently by them-

selves nor by costs, but are rather the result of a host of influences including demand as well as supply, and demand not only for the article in question, but for an infinite number of goods and services which may be consumed instead.

It can be seen that the two theories are in many ways far apart, yet, from the standpoint of results and public policies to be pursued, come to similar conclusions. The modern classical theory would not deny the essentials of the equilibrating process, nor would the equilibrium theory pretend that cost analysis is of no significance in explaining trade ratios and conditions.

## CHAPTER 18

# HISTORY OF INTERNATIONAL MONETARY THEORY

The theory of money and the theory of international trade developed side by side, but to a considerable extent each independently of the other. Economists historically regarded the value and the monetary phases of economic theory as largely separate and distinct. The theory of money was not considered an integral part of general economic theory, but was tacked on as a sort of appendage. Here was the theory of value, price relationships, distribution, and such matters, while over there was the theory of money and the foreign exchanges. Only in recent years have monetary theory and other phases of economic theory been generally merged into a single whole, and treated as parts of a unified theory of economics.

**Beginnings of International Monetary Theory.**<sup>1</sup>—Rudiments of the quantity theory of money go back to ancient times, but most early statements are little more than casual recognition of a general relationship between the quantity of money and the value of the unit of money. For example, Xenophon in the fourth century B.C. noted that if gold appeared in great quantity, it became much less valuable. Aristotle (384–322 B.C.) also recognized the importance of the quantity of money in the determination of its value. In his *Politics*, Aristotle attempted to show how barter, and later trade with money, originated. He declared that

barter, in general, had its original beginning in nature, some men having a surplus, others too little of what was necessary for them.

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<sup>1</sup> For discussion regarding the evolution of money and the various forms of early money see pages 18–19.

. . . It is plain that barter could have no place in the first, that is to say, in family society; but must have begun when the number of those who composed the community was enlarged: for the first of these had all things in common; but when they came to be separated they were obliged to exchange with each other many different things which both parties wanted. Which custom of barter is still preserved amongst many barbarous nations, who procure one necessary with another, but never sell anything; as giving and receiving wine for corn and the like.<sup>2</sup>

The inconveniences of barter, according to Aristotle, led to the invention of money:

But this barter introduced the use of money, as might be expected; for a convenient place from whence to import what you wanted, or to export what you had a surplus of, being often at a great distance, money necessarily made its way into commerce; for it is not everything which is naturally most useful that is easiest of carriage; for which reason they invented something to exchange with each other which they should mutually give and take, that being really valuable itself, should have the additional advantage of being of easy conveyance, for the purposes of life, as iron and silver, or anything else of the same nature: and this at first passed in value simply according to its weight or size; but in process of time it had a certain stamp, to save the trouble of weighing, which stamp expressed its value.<sup>3</sup>

One of the most remarkable of the early statements on money was that of Julius Paulus, the prolific Roman Jurisconsul who died, or rather was put to death, in 230 A.D. He said, "That material which has been struck with the public stamp (as coin), has use and value, not so much from its substance as from its quantity."<sup>4</sup> Here is a clear-cut quantity explanation of the value of money. Numerous statements emphasizing the importance of the quantity of money in the determination of its value can be found all through literature from Greek and Roman times on down to the more careful monetary studies of the last century or two.

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<sup>2</sup> Book I, Ch. IX.

<sup>3</sup> *Ibid.*, Book I, Ch. IX.

<sup>4</sup> Julius Paulus, *Pandectus*, II, Book XVIII, 147; quoted by E. W. Kemmerer, *Money and Prices*, New York, Henry Holt & Co., 1909.



Important contributions in the field of monetary theory and the relation of money to trade were made during the sixteenth to eighteenth centuries, more or less independently of the rise and decline of mercantilist doctrine. As already noted, several of the mercantilists had an understanding of the effect of changes in the quantity of money upon commodity prices.<sup>5</sup> Petty (1623-1687) pointed out that raising the denominations of coins but leaving the bullion content unchanged would merely increase the number of units of money that could be made from a given quantity of bullion, and so raise prices, but would not add to the total value of a country's money. Petty, however, had no clear conception of the quantity theory of money. Inasmuch as the mercantilists gave considerable attention to foreign trade, they had some knowledge of the relation of the flow of specie to the balance of trade, namely, that a large outward movement of goods tended to cause an inward movement of specie. Although they had a certain grasp of the quantity theory, nevertheless, they were not particularly concerned with the general bearing of this theory upon their main doctrine that a large supply of specie was especially desirable.

The French economist, Jean Bodin (1530-1596), made noteworthy observations on money. The period during which Bodin lived saw an enormous flow of the precious metals into Europe from the recently discovered New World. As a result of this inflow of gold and silver, commodity prices increased greatly, to about three times their former level. Bodin was apparently the first writer to connect this rise in prices with its underlying cause. He showed that popular explanations of the rise in prices were entirely inadequate, and that the real cause was to be found in the enlarged supplies of money. His reasoning, though elementary as viewed today, was a step forward and had a wide influence on continental and British thinking.

John Locke (1632-1704) and David Hume (1711-1776), both of whom are perhaps more widely known as philosophers than as economic thinkers, contributed a great deal to monetary

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<sup>5</sup> Viner discusses this in his *Studies in the Theory of International Trade*, pp. 40-45. He points out that Malynes, Mun, Sir Robert Cotton, Henry Robinson, and other early British writers adhered to a simple quantity theory of money.

theory. John Locke is generally credited with being the first to present a definite and careful analysis of the theory of money. Denying that money has "intrinsic" value, Locke declared that "the *value of money* in respect of those [other goods] . . . depends only on the plenty or scarcity of money in proportion to the plenty or scarcity of those things."<sup>6</sup> Locke further recognized that the amount of money required to keep the value of money at a particular level "depends not barely [merely] on the quantity of money but on the quickness of its circulation."<sup>7</sup>

Locke, however, overlooked significant international implications of his doctrine. While he perceived that a country, by losing money, would tend to have lower prices, he failed to recognize that this situation would tend automatically to correct itself, the lower prices stimulating sales abroad and discouraging purchases there, thus tending to check the outflow of money.

David Hume, by analyzing the relationship of price levels in different countries and the functioning of the quantity theory of money internationally, pointed out what Locke had apparently failed to grasp, namely, that low prices in one country would attract money from other countries, thereby tending to raise these prices until they were in harmony or equilibrium with prices throughout the world. His words to this effect are:

Suppose four-fifths of all the money in Great Britain to be annihilated in one night, . . . what would be the consequence? Must not the price of all labor and commodities sink in proportion . . .? What nation could then dispute with us in any foreign market, or pretend to navigate or to sell manufactures at the same price, which to us would afford sufficient profit? In how little time, therefore, must this bring back the money which we had lost, and raise us to the level of all the neighboring nations? Where, after we have arrived, we immediately lose the advantage of the cheapness of labor and commodities; and the farther flowing in of money is stopped by our fullness and repletion.<sup>8</sup>

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<sup>6</sup> Locke, *Consequences of the Lowering of Interest* (1691), as quoted in James W. Angell, *The Theory of International Prices*, p. 18. Cambridge, Harvard University Press, 1926.

<sup>7</sup> Locke, *ibid.*, as quoted in Angell, *ibid.*, p. 19.

<sup>8</sup> From Hume's essay, "Of the Balance of Trade," in his *Political Discourses* (1752), as quoted in A. E. Monroe, *Early American Thought*, Cambridge, Harvard University Press, 1924, p. 325.

This analysis of Hume, now often referred to as the "price-specie-flow analysis," was taken over by the English classical theorists. According to this doctrine, prices in all countries are related to each other, so that price movements in one country tend to affect prices in other countries as well. In any particular country, the level of prices is governed essentially by the quantity of money circulating there. If, however, prices in one country are lower than the equilibrium level, exports from that country will as a result tend to be increased to the extent that gold will flow into such country in payment for the exports. This inflow of money will tend to raise prices and incomes there until equilibrium is restored. The opposite situation will tend to occur where prices in a country are higher than the equilibrium level.

Hume also pointed out that the narrow movements of exchange rates within the gold-import and gold-export points tended to check a "wrong balance of trade." "When we import more goods than we export," he wrote, "the exchange turns against us, and this becomes a new encouragement to export; as much as the charge of carriage and insurance of the money which becomes due would amount to. For the exchange can never rise but a little higher than that sum."<sup>9</sup> This statement, it will be noted, refers to physical goods and fails to include invisible items. It was, however, another step forward, and reveals that Hume had some practical knowledge of foreign-exchange transactions.

Montesquieu in 1748, in *L'Esprit des lois*, presented a quantity theory analysis. He said:

An increase in the quantity of gold and silver is then advantageous when one regards the metals as articles of merchandise, but not when one regards them as tokens, because their value as tokens, being largely dependent on their scarcity, is decreased by abundance. . . .

If, since the discovery of the Indies, gold and silver in Europe have increased in the ratio of one to twenty, prices of commodities must have risen in the ratio of one to twenty. But if, on the other

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<sup>9</sup> Hume, *op. cit.*, as quoted in Monroe, *op. cit.*, p. 326.

hand, the amount of commodities has increased in the ratio of one to two, it must be that prices have on the one side risen in the ratio of one to twenty, and that, on the other, they have fallen in the ratio of one to two, so that they actually stand, in consequence, at the ratio of only one to ten.<sup>10</sup>

**Classical Monetary Theory.**—Classical economists, as indicated above, were inclined to regard monetary questions as of secondary importance, and as separate from the main body of economic theory. They held that economic phenomena are best understood by centering attention upon goods and services, which are the end of economic activity, rather than upon money, which they alleged, often conceals basic economic relationships.

By the time of Adam Smith, whose *Wealth of Nations* appeared in 1776, the main outlines of the quantity theory of money together with the self-regulating mechanism of international price levels, were fairly well developed. Smith accepted these theoretical foundations and did little, if anything, to refine them. In fact, in the *Wealth of Nations* he is less clear than Hume on the distribution of specie and on international price level relationships. His great achievement lay in a demonstration of the fallacies of mercantilism, and in setting forth the case for international specialization and free trade.<sup>11</sup>

Although the classical economists dealt with money separately and tended to subordinate its importance, they by no means neglected the general theory of money. Ricardo is especially noted for his grasp of monetary matters. This was particularly evident in the long controversy in England over currency and exchange movements during the Napoleonic wars. In this so-called "bullion controversy," the issue was essentially whether or not, after specie payments were suspended by England in 1797, the rise in commodity prices, the fall in exchange rates, and the premium on bullion or so-called high price of

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<sup>10</sup> Quoted by J. Laurence Laughlin, *The Principles of Money*, New York, Chas. Scribner's Sons, 1916, p. 230.

<sup>11</sup> Viner points out that although Smith in an earlier writing summarized approvingly Hume's price-specie-flow analysis, in the *Wealth of Nations* he makes no reference to this, but on the contrary reverts to the then obsolete explanation of specie distribution in terms of the requirements of a country, that if a country has too much money the money seeks profitable employment abroad. Viner, *op. cit.*, p. 87.

bullion, represented currency depreciation and an excessive issue of money. The "bullionists," led by Ricardo, held that the rise in prices, low exchange rates, and the premium on bullion were merely evidence of depreciation of the currency, which in turn was the result of over-issue. The "anti-bullionists" denied this, and tried to maintain that the currency was not redundant or depreciated, but that the trouble lay with bullion itself. The question as we view it today seems, in its larger aspects at least, simple, and the trouble obvious, as it did no doubt to most of the economists of that period. In this controversy, Ricardo's forceful presentation of monetary doctrine and his clear analysis of the issues influenced greatly monetary thinking for years to come.

Ricardo, in stating his doctrine of comparative costs (real costs) in terms of money and prices, maintained that in the long run the movement of goods in international trade is the same under a monetary economy as it would be under a system of barter. Monetary costs, according to Ricardo, are merely a reflection of real costs, i.e., labor costs. Although actual trade takes place in terms of money, this, he declared, does not alter the basic situation. To substantiate this contention, Ricardo made use of Hume's monetary analysis, according to which gold settles a deficit in the balance of trade and alters price level relationships. Referring to his original illustration, Ricardo showed what would happen if England, as a result of the discovery of a new process for making wine, found it to her advantage to produce her own wine rather than to import it. In this event, said Ricardo, Portugal would continue for a time to import cloth from England, since the price of cloth would remain unchanged. Since, however, Portugal would no longer be able to pay for the cloth with her wine, she would be forced to export gold to England, which would raise prices and money costs in England and lower them in Portugal until it would no longer pay Portugal to import cloth. If the improvement in making wine in England were very great, it might be advantageous for the two countries to exchange their specialties, England producing wine and Portugal cloth. In this event, the changed situation would result in a new distribution of the

precious metals, and trade would again proceed as if on a barter basis.<sup>12</sup>

Nassau William Senior (1790-1864) gave considerable attention to money. He included credit in the monetary supply and therefore in the factors affecting prices. A greater use of book credits, he pointed out, would influence prices in the same manner as an issue of paper money.

John Stuart Mill, writing about the middle of the nineteenth century, followed the general reasoning of Ricardo. He agreed with Ricardo that in the long run the terms and direction of international trade would be the same under a monetary economy as under a system of barter. Mill did not add greatly to international monetary theory, but he modified and refined the quantity theory, developing the rôle of "rapidity of circulation." He believed, however, that under most circumstances the velocity of circulation and the volume of trade were relatively unimportant factors, and that it was the quantity of money that was of special consequence. Like Senior, Mill recognized that credit should be considered as no different from money in its effect upon prices.<sup>13</sup>

The fact that a given amount of gold can support a much larger volume of bank credit, thus making international price adjustments more rapid than would otherwise be possible, was appreciated by many of the nineteenth-century economists. It was shown that where credit is used as money, prices tend to fall more rapidly when gold is leaving a country, and to rise more rapidly when gold is entering a country, than is possible under a system where gold is the only currency and is not used to support bank credit.

Currency understanding was promoted by the active dis-

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<sup>12</sup> Certain critics of the classical school, such as Bertrand Nogaro of France, have not shared the conviction that money is of but secondary importance in international-trade theory. They have criticized classical writers for failing to devote adequate attention to the international aspects of money, declaring that the Ricardian monetary analysis is greatly oversimplified, and have maintained that the money factor, in the long run as well as in the short, can affect the direction and character of international trade.

<sup>13</sup> Mill wrote: "Credit which is used to purchase commodities affects prices in the same manner as money. Money and credit are thus exactly on a par in their effect on prices; and whether we choose to class bank notes with the one or the other is in this respect entirely immaterial." (*Principles of Political Economy*, Book III, Ch. XII.)

cussions in England prior to revision of the statutes relative to the Bank of England by the Bank Charter Act of 1844. At that time it had come to be realized in economic circles that bank discount policies and the expansion and contraction of bank notes affected the price level and were therefore factors in exchange rates, specie movements, and also in fluctuations in business conditions. The recurring periods of prosperity and depression were recognized as being related to monetary expansion and contraction. The proper method of dealing with this situation, however, was a matter of controversy.

The so-called Currency School argued that if the aggregate volume of currency were allowed to fluctuate exactly as it would if it consisted entirely of specie, all would be well. This group did not consider deposits as money and confined their definition of money to bank notes and coin. They therefore believed that in order to accomplish their objective of limiting monetary expansion to that of specie, Bank of England notes should not be allowed to increase unless backed 100% by specie. This would cause the volume of money to conform to the specie volume. They also had implicit confidence in the satisfactory functioning of the automatic gold standard. Their line of reasoning, known as the Currency Principle, it will be noted, was based upon this assumption.

The opposing group, known as the Banking School, differed considerably among themselves, but in general emphasized the importance of deposits in the monetary structure. They therefore attached special significance to the discount and lending policies of banks and the effect upon deposits. The volume of notes, it was said, adjusted itself to the needs of merchants, whereas the volume of deposits fluctuated with an expansion or contraction of loans. It was further argued that if the expansion of deposits was a result of loans which represented actual business and commodities in existence, no harm would come. Therefore, banks might properly be allowed to maintain partial reserves, but they should limit their loans to short-term commercial transactions.<sup>14</sup> The Banking School, like the Currency

<sup>14</sup> This theory of the automatic and inherent soundness of short-term self-liquidating paper is the same as that embodied in the Federal Reserve Act of 1913.

School, did not question the satisfactory nature of the automatic gold standard. Both groups failed to realize the need for a certain amount of conscious control over currency and banking matters.<sup>15</sup>

Both schools of thought recognized that disequilibrium between the domestic price level and foreign price levels would tend to cause the movement of gold. The Currency School felt that this was the only cause of gold movements, whereas the Banking School pointed out that fear and other conditions might lead to an alteration of exchange rates and to gold movements. The Banking School also pointed out that a loss of gold would not immediately cause a contraction in the volume of money since exports of gold would come largely out of bank reserves. Only as banks, with lowered reserves, raised interest rates and discouraged borrowing would the currency volume tend to contract.

Among the prominent writers and participants in the controversy of this period were Thomas Tooke and John Fullarton, who stand out for their clear thinking and understanding of the essential issues. Tooke wrote extensively on financial questions and is well known (with W. Newmarket) for their six-volume work, *A History of Prices and of the State of the Circulation during the Years from 1793 to 1856*. Fullarton urged that all gold reserves be held by the Bank of England and that the Bank be given wide discretion over the reserve which it maintained.

**International Monetary Theory after 1850.**—Following the discovery of America and the large stock of mined and unmined precious metals there, the European supplies and the world production of gold increased greatly, particularly after about 1680. The very spectacular increase in gold production, however, came much later, beginning shortly before 1850. It is still continuing. This great increase followed the gold discoveries in California (1848) and Australia (1851), and later in Alaska (1880)<sup>16</sup> and South Africa (1884). It was also the result of the inven-

<sup>15</sup> The Act of 1844 which rechartered the Bank of England embodied the philosophy of the Currency School, tying rigidly the volume of notes to the volume of specie. Since the use of deposits was growing, whereas that of bank notes was becoming less important, England, nevertheless, had in fact an elastic currency.

<sup>16</sup> The Klondike rush began in 1896.



tion of the cyanide process which came into use late in the century and which made possible the extraction of gold from poorer grade ores. This process greatly expanded the production of the South African mines where the accumulations of discarded ores were reworked. In the decade ending in 1840 world gold production averaged about 652,000 ounces per year, while by 1854 it had climbed to 7,102,000 ounces and by 1915 to 22,678,000 ounces.<sup>17</sup> In 1941, after the price of gold had been raised by the United States (1933) and others, gold production amounted to about 42,000,000 ounces.

This period of unusually large gold production saw the adoption of the gold standard by most of the leading countries of the world which did not already have it. Largely as a result of this, the commodity price level, in terms of gold, was declining from about 1873 to 1896. It then rose, accompanying new increases in gold production, to 1914 when paper currency and deposit inflation in most countries carried the rise very much further.

During these decades of currency change and price level upheaval, it is logical that monetary thought should be concerned particularly with forces affecting the value of money. Thus John E. Cairnes and W. Stanley Jevons discussed at length the effects of the new gold upon prices and its distribution throughout the world. Controversy raged over the validity of the Quantity Theory, and over the relation of the value of gold to the use of gold as money. The Quantity Theory emphasized the quantity of monetary units, regardless of the commodity value of the material of which the money was made. This view was vigorously denied by those who declared that the value of money rested upon the usefulness of its commodity content, and in the case of fiduciary money upon its redemption in specie, present or prospective. Inconvertible money was held to be valuable because of confidence in ultimate redemption.<sup>18</sup>

The German economist, G. F. Knapp, in his *State Theory of*

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<sup>17</sup> Cf. Annual Report of the Director of the Mint.

<sup>18</sup> Some of the principal participants in the currency discussions of this period were W. Stanley Jevons, Francis A. Walker, J. S. Nicholson, Alfred Marshall, Leon Walras, Simon Newcomb, Friedrich Wieser, Knut Wicksell, G. F. Knapp, and J. Laurence Laughlin.

*Money* argued that money was a creature of law, and that the value of money was based on the fact that the state secured the validity of money. He overlooked the fact that governmental regulations were a means of limiting the quantity of money.

Knut Wicksell, shortly before the turn of the century, pointed out the difference between what he called the natural rate of interest and the market rate of interest. An increase in the supply of money, he said, tended to lower interest rates just as did an increase in the supply of savings available for lending. The natural rate was that which equated savings and the demand for loanable funds, while the market rate was affected by the monetary supply of credit. Divergence of the market rate from the natural rate caused what he called a cumulative process, involving inflation or deflation and leading to economic disturbances. When the market rate is below the natural rate, he said, prices will rise.

In the early years of the twentieth century, interest in the theory of money was stimulated by the studies of several American writers, notably Irving Fisher and E. W. Kemmerer. Kemmerer's *Money and Prices* presented a strong case for the Quantity Theory and undertook a statistical verification of the theory in terms of his algebraic equation. A few years later appeared Fisher's *The Purchasing Power of Money* (1911), in which Fisher introduced his well-known equation of exchange, referred to in a previous chapter.<sup>19</sup> The first algebraic statement of the equation of exchange was made by the famous astronomer and economist, Simon Newcomb, a clear thinker in the field of currency, in his book, *Principles of Political Economy*, which appeared in 1885. Irving Fisher recognizes his indebtedness to Simon Newcomb with respect to the equation of exchange. Fisher, Kemmerer, and, more recently, Carl Snyder, Warren and Pearson, and others have made statistical investigations regarding the Quantity Theory. Snyder showed clearly that when the monetary supply expanded faster than the growth of physical production, a rise in prices resulted, and vice versa. He urged that the monetary supply be so regulated that its rate of growth correspond to that of business.

<sup>19</sup> Chapter 12, Money, Prices and Trade.

During the first World War and the post-war period, disordered currency systems, drastic price rises, and widely fluctuating exchange rates commanded the attention of people in all countries. One of the most significant theoretical contributions of this period was the purchasing power parity doctrine, advanced in 1916 by Gustav Cassel of Sweden.<sup>20</sup> Referring particularly to paper monetary systems, Cassel reasoned that the exchange rate of one country on another would tend to remain the same so long as the price levels in the two countries did not change, or so long as the price levels rose or fell together and at the same rate. If, however, only one of the price levels was changing, or if both price levels were changing but at different rates, the exchange rate between them, according to Cassel, would tend to move in such a way as to reflect the new value relationship between the two currency units. In Cassel's own words:

Given a normal freedom of trade between two countries, A and B, a rate of exchange will establish itself between them and this rate will, smaller fluctuations apart, remain unaltered as long as no alterations in the purchasing power of either currency is made and no special hindrances are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished, the value of the A-money in B must necessarily be reduced in the same proportion. . . . Hence the following rule: when two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from this new normal rate, and in a period of transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity between the currencies. This parity may be called the *purchasing power parity*, as it is determined by the quotients of the purchasing powers of the different currencies.<sup>21</sup>

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<sup>20</sup> This theory is discussed at greater length in Chapter 13. Cassel revived rather than originated the purchasing power-parity doctrine. According to Professor Angell (*op. cit.*, p. 52), the doctrine was first stated in clear-cut form by John Wheatley in 1803. See also Frank Whitson Fetter, "The Life and Writings of John Wheatley," *Journal of Political Economy*, June, 1942.

<sup>21</sup> Gustav Cassel, "Memorandum on the World's Monetary Problems," International Financial Conference, Brussels, 1920, *Documents of the Conference*, Vol. V, pp. 44-45.

The doctrine as originally stated by Cassel overlooked the fact that trade between countries may change as a result of various factors that are entirely apart from price level movements. An altered trade situation means (probably) a change in the demand and supply of bills, and consequently a different rate of exchange. In other words, a change in reciprocal demand may mean a change in the equilibrium rate of exchange. The theory also failed to take account of the fact that the price level of domestic goods may change markedly without seriously affecting foreign trade and exchange rates.<sup>22</sup> Cassel later modified his statement to allow for these deficiencies.

In spite of its theoretical limitations, which Cassel was quick to acknowledge, the purchasing power-parity doctrine was of practical value at a time when even well-informed statesmen were unaware of the close connection between inflationary policies and movements in exchange rates. Cassel's theory emphasized that internal depreciation was at that particular time the most important factor in the depreciation of the foreign exchanges. The purchasing power parity doctrine and its limitations are discussed more fully in Chapter 13.

In recent years, English writers, particularly A. C. Pigou, R. G. Hawtrey, D. H. Robertson, and John Maynard Keynes, have developed a different approach to the theory of money in which they emphasize the demand for money as indicated by the cash balances, or "unspent margin" as Hawtrey calls it, which people hold. This Cambridge theory, as it is sometimes known, draws attention to the desires or needs of people to hold a certain amount of money at all times, and of their choices of whether to hold money or to spend it. It relates the theory of money more closely to the general theory of value since it stresses the fact that people are constantly comparing the importance to them of the goods which money could buy with the importance to them of the money itself as liquid cash. It will be noted that the matter of the cash balances which people hold is taken care of in Fisher's equation in the items  $V$  and  $V'$

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<sup>22</sup> If domestic goods fall greatly in price, they may become cheap enough to compete in the foreign market. But where this is the case, they cease to be domestic goods, so that the above generalization—that the price level of domestic goods may greatly change without affecting exchange rates—remains valid.

representing the velocity of money and of deposits respectively. An increase in cash balances held means a slowing down of  $V$  and  $V'$ .

The alternating periods of prosperity and depression during the past few decades have drawn attention increasingly to the relation of these fluctuations to the expansion and contraction of money. In the economic discussions prior to about 1920, the effect of changes in the volume of money upon prices was more clearly perceived than the effect of these volume changes upon the flow of income and upon economic conditions generally. The 1914 war and particularly the economic collapse which began in 1929, however, gave impetus to a study of the broader aspects of the currency question.

Among the many economists who wrote on the relation of money to the business cycle was F. A. Hayek. In his *Monetary Theory and the Trade Cycle*,<sup>23</sup> he developed the theory that "forced savings" (resulting from the loss to holders of money when prices rise) lead to excessive expansion of the capital goods industries and to economic disturbances. He proposed a system of so-called neutral money, wherein the aim would be to have money play a purely passive rôle.

The theories of John Maynard Keynes, which have aroused widespread interest among economists, have been concerned especially with the interrelations of employment, money, and investment. Keynes argues that in an advanced economy, such as prevails in the United States and England, the rate of return on capital is too low to maintain new investment at a level sufficient to provide full employment of workers and resources. Savings, he says, tend to outrun the utilization for investment of the savings. Government should, therefore, he maintains, meet this deficiency through public works and governmental undertakings. Keynes' theories have done much to integrate monetary theory and general theory.

At the time of the adoption of the Federal Reserve Act in 1913, it was thought that regulation of monetary expansion and contraction should be semi-automatic, in that the banking authorities should be guided in their credit policies primarily by the

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<sup>23</sup> New York, Harcourt, Brace & Co., 1932.

state of the gold reserve. If gold was leaving the country the bank should raise discount rates and tighten credit, and vice versa. This reasoning obviously assumed the satisfactory functioning of the automatic gold standard. The functioning of the gold standard was relatively unchallenged except from the standpoint of price level instability. The causes and results of fluctuations in the velocity of money, and the extensive consequences of monetary movements, were then only vaguely perceived. The principal objective of currency and banking policy was regarded as maintenance of redemption in gold and, consequently, of relative foreign exchange stability in terms of gold.

The accepted doctrine regarding bank loan and discount policy was that fluctuations in the volume of deposits, resulting from bank loans, should be made to coincide with those of actual business, in so far as this was possible within the limits set by the gold reserve. This doctrine of the desirability of a close correspondence between the supply of money and the volume of business has, of course, much to be said for it. It implies, however, that the volume of business is something fixed and apart from the supply of money, to which the supply of money is to be adjusted. Preferable to this type of adjustment is an adjustment of the money supply with the object of attaining, in so far as possible, an optimum volume of business and production.

It was thought that the former aim of a close correspondence between the supply of money and the volume of business would be accomplished if banks confined their lending primarily to loans which represented actual business transactions, and which were short-term and self-liquidating. The deposit expansion resulting from these loans, it was thought, would then be accompanied by an equal, and consequently justifying, expansion in business. Conversely, deposit contraction would be the result of a contraction in business borrowing. Furthermore, the banking system would remain liquid. The Federal Reserve Act of 1913 was based on these principles and thereby embodied what was regarded as the best in monetary and central banking philosophy that had developed from the discussions of the previous one hundred years.

The speculative boom and collapse of the nineteen twenties, however, showed clearly that in the United States the machinery, worked out on the above lines and intended to provide an automatic adjustment of deposits to business, was inadequate, and that excessive credit expansion and contraction could still take place. Even though the central bank confined its loans to those which were of a short-term, self-liquidating nature and which represented legitimate business transactions, the banking system as a whole was not compelled to, nor did it, so confine itself. Furthermore, even though banks were to confine themselves to loans of this type, there was nothing to prevent businesses which formerly had not been financed by borrowings, from being so financed, so that an expansion of loans, and consequently of the supply of money, did not necessarily have to represent a corresponding expansion in business. This was exactly what happened in the United States in the 1920's when deposits expanded far beyond the needs of actual business. The new money was used to finance a speculative orgy, followed by collapse.

The breakdown in currency and banking systems and the accompanying price collapse led to a reexamination of the theoretical bases and practical operation of these systems, and to efforts to devise more satisfactory methods of regulating the supply of money. The heart of the problem is essentially how to obtain a better adjustment of the volume of money to the demand for money, including that for hoarding, and how to avoid having monetary movements (erratic fluctuations in the demand for money, as well as in the supply) interfere with the flow of income with such devastating consequences as were experienced during the 1930's. Various proposals intended to accomplish these objectives were brought forth and commanded the support and also the opposition of outstanding economists. These included the 100% money proposal promoted by Irving Fisher, which would prevent deposits from expanding and contracting accompanying bank lending activities, and the commodity reserve plan of Benjamin Graham which would permit the unlimited monetization of certain basic and stable commodities and, conversely, the redemption of money in these commodities.

The increasing regulatory activities of government over economic life generally, and the direct control over prices developed during the war, supplemented and to some extent replaced efforts to attain more basic monetary adjustments.

As a result of the world-rocking events of the past two decades, involving all countries, the leading rôle of the monetary system in economic life has become more evident and the sphere of monetary theory has thus expanded. As noted, economists have been exploring new ground, and the recent years have consequently been ones of controversy. Particularly has this been the case with reference to the extent to which general economic stability and full employment can be attained through monetary devices. The international ramifications of the money problem, price level relationships, and exchange fluctuations have all been reexamined. Governments have adopted new currency procedures, gropingly attempting to deal with situations which could not be postponed. As is usually the case theory has outpaced practice, in spite of the disputations of economists. Currency reform remains one of the major economic problems awaiting constructive action.<sup>24</sup>

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<sup>24</sup> Space has not permitted reference to all the economists, past and present, who have made worthwhile contributions in the field of international monetary theory.



PART III  
INSTITUTIONS AND PROCEDURE



## CHAPTER 19

### FINANCING FOREIGN TRADE: BILLS OF EXCHANGE

**The Financing Function.**—Modern production is usually a very roundabout process involving several stages, and large outlays of capital for labor, materials, and equipment. Until the goods are finally sold and the money received, the financial burden on the producer is frequently heavy. The distribution or marketing of the goods is usually undertaken by a person other than the producer, and also involves an outlay of money. Sometimes the entire expense of producing and marketing goods is borne by the producer alone, but ordinarily it is shared by the middleman or seller. The assistance of a bank is often sought in providing the necessary money. The advancing of funds for the production and distribution of goods is what is meant by the expression “financing trade.”

Fundamentally there is little difference in the financing of foreign trade and domestic trade. In foreign trade the time interval during which trade needs financing is usually longer because goods are shipped greater distances. Furthermore, in foreign trade the importer usually desires a longer period in which to pay. During this time he hopes to dispose of the goods; if raw materials, to work them up into finished products and sell them, thereby receiving money with which to make payment. The importer, of course, has some capital of his own, but may lack enough to pay completely for his goods in advance of selling them. In international trade the finance burden is occasionally assumed entirely by the exporter, and in some cases by the importer, but the usual practice involves the assistance of a bank.

Since buyer and seller are usually farther apart in foreign than in domestic trade, the exporter may find it more difficult to ascertain the credit standing of his customers. Conversely, it

is less easy for the importer to determine the integrity and reputation of the foreign firms from which he may wish to buy than if they were located in his own country. In domestic trade the matter of what monetary unit to employ is simple, whereas in international trade the question of currency and exchange may complicate the financing. It introduces an extra hazard, and in some instances even prevents a transaction. In other respects the financing of foreign trade is not very different from that of domestic trade.

**Methods of Payment.**—Wide variations exist in the procedure of financing foreign trade. Certain customs and practices regarding financing arrangements pertain to the different commodities and to different countries.

The simplest, but by no means the commonest, method involves payment in advance, in which case the entire finance burden is borne by the importer. In such a case the importer makes payment by remitting to the exporter a bank draft when ordering the merchandise or before shipment.

Such procedure is exceptional in foreign trade. While ideal from the seller's point of view, this method is obviously disliked by the buyer, since he is forced to accept all risks in transit, in exchange fluctuations, and in the quality of goods received. Buyers usually consider it a reflection on their credit standing to be asked to remit in advance. Consequently, use of this method is ordinarily confined to financing shipments of samples, small amounts of consumptive goods, made-to-order merchandise, or to shipments in periods of political uncertainty when a sudden crisis or governmental action might interfere with payment. When expensive products, such as special types of machinery, are made to order, some kind of advance-payment arrangement may be requested, although the entire price may not be asked for at one time. A common plan calls for the payment of one-third the purchase price with the order, one-third upon shipment, and one-third within a specified period after receipt of the product by the buyer.

According to the open-account method, shipments of merchandise are charged to the account of the buyer as they are

made, much in the same fashion that domestic retail stores advance credit to their customers. This places the entire finance burden upon the exporter. This loose procedure is of course advantageous to importers, since it ordinarily creates no legal obligation to remit at any definitely stated time. The importer is enabled to adjust his payments to receipts from customers, and can take advantage of favorable exchange rates (or at least attempt to profit thereby).

The open-account method is avoided by most exporters, although it is convenient in that it eliminates the need for special papers and arrangements. The chief disadvantage of this method is that it ties up large amounts of the exporter's capital, since banks usually dislike to advance funds against accounts receivable. Also, aside from assuming the finance burden, the exporter is largely at the mercy of the buyer's good faith, there being no documentary security. It opens the door for misunderstandings which may require acquiescence by the exporter in order to retain the good will of his customer. In the event of a dispute, the exporter must prove that the goods were delivered exactly in accordance with the sale contract. Laxity in making payments is obviously encouraged, even though the importer may have no desire to evade his obligations.

Some of these disadvantages can be avoided by previous arrangements between the parties. For example, it is usually agreed that payments are to be made at stipulated intervals, perhaps every three months. Interest is often charged on unpaid balances. The exporter generally sets a maximum credit limit beyond which the buyer cannot make further orders on credit.

Open-account financing is used less in foreign than in domestic trade, and has been declining in importance in domestic trade. It is sometimes extended by exporting firms as an accommodation to foreign buyers of unquestioned standing. It is frequently granted to foreign commission houses with long experience as buying agents for foreign importers. European exporting concerns which have had intimate business relations with their buyers for many years often employ open-account arrangements.

In arranging for a shipment of goods, the question of who is to pay the freight is always agreed upon in advance. The prices quoted by the seller may be f.o.b. (free on board) at a specified location such as the factory, which means that the buyer pays the freight; if the terms of sale are c.i.f. (cost, insurance, and freight) these items are borne by the seller; the letters f.a.s. (free alongside) mean that the seller will deliver the goods alongside the ship, paying freight to that point.

**The Bill of Exchange in International Trade.**—Thus far we have discussed only briefly the mechanics or technique by which foreign payments are made or funds transferred from one country to another. To describe this involves a consideration of the draft, or bill of exchange, which is the fundamental instrument in international finance.

The draft is supposed to have been first introduced into international trade by the Lombardian Jews, early traders of northern Italy, who used it as a means of avoiding the shipment of large quantities of gold and silver. It is now used in virtually all international commercial transactions. The bill of exchange in appearance and function resembles the common bank check, as can be seen from Figures 4 and 5. It is an order signed by the maker, called the *drawer*, directing another party, the *drawee*, to pay a specified sum of money to a third party, the *payee*, at a certain future date.

£ 10,000/0/0

Los Angeles, January 3, 1943

Ninety (90) days after sight of this

First of Exchange (second unpaid) pay to the order of

**THE NATIONAL CITY BANK OF NEW YORK**

**FIRST**

Value received in full, charge to the account of

Liverpool Company, Ltd.

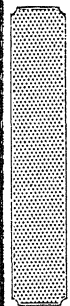
London

(Signed) John Doe

**SPECIMEN**

Figure 4. A Commercial Bill of Exchange

Bills of exchange are ordinarily drawn by exporters in connection with shipments of merchandise, or are drawn by bankers on other banks. The former are known as commercial bills of exchange, or trade bills, while the latter are known as bankers' bills, or bankers' drafts. The commonest procedure is for the exporter, upon shipment of his goods, to draw a bill either on the importer or, as we shall see later, more frequently on a bank acting for the importer. The exporter usually draws the bill payable to his own order, or to that of his bank. He then endorses the bill, and sells or discounts it at his bank. In this

	£ 10,000/0/0	Los Angeles <small>CITY</small>	January 3, 1943 <small>DATE</small>
	Ninety (90) days after sight of this		
	<i>Second of Exchange (first unpaid) pay to the order of</i>		
	<b>THE NATIONAL CITY BANK OF NEW YORK</b>		
	<b>SECOND</b>		
<i>Value received, and paid, and charged to the account of</i>			
_____			
Liverpool Company, Ltd.			
London			
(Signed) John Doe			

SPECIMEN

Figure 5. Duplicate of Commercial Bill of Exchange

way the exporter may receive his money immediately upon the shipment of the goods. A sample of a commercial bill is shown in the accompanying illustration (Figure 4). In this 90-day sight bill, John Doe, the exporter, has drawn on the Liverpool Company, Ltd. of London for £10,000, payable to the order of the National City Bank of New York. The draft, it will be noted, is drawn in duplicate, one being marked First of Exchange (second unpaid), and the other Second of Exchange (first unpaid), (Figure 5). The drafts are sent by separate boats so that if one boat is delayed or meets with a mishap the other draft will arrive as intended. The first draft to arrive is paid. This practice dates back to the days when shipping was precarious.

The bank which discounts or buys the bill is protected in two ways. It has the written endorsement of the exporter, which makes him legally liable to pay the draft if it is not otherwise paid. The bank also has possession of the bill of lading and other documents which the exporter turns over with the draft. The bill of lading is the receipt of the steamship company or railroad for the goods and gives title to the goods. The bank can, if necessary, thus secure possession of the exported merchandise.

The bank mails the bill of lading, insurance papers, and other documents, along with the draft, to its foreign branch or correspondent bank, which, upon arrival, promptly notifies the importer and presents the draft to him for payment or acceptance. Until the importer has accepted the draft or made arrangements for payment, he cannot receive the bill of lading permitting him to get possession of the goods. In accepting a draft, the drawee (on whom the bill is drawn) writes the word "accepted" above his signature across the face of the instrument, thus becoming legally bound to pay the obligation when due.

If the draft calls for immediate payment, the foreign correspondent collects from the importer and then remits to the home bank, which is thus reimbursed for the funds advanced to the exporter. If the draft is a time bill and acceptance is called for, the foreign bank, after having the draft accepted, possesses an instrument which is guaranteed both by seller and buyer. The accepted draft is known as a "trade acceptance," and can either be held by the foreign bank until due or, if funds are desired immediately, the draft can be sold in the open market—at a slight discount, depending upon the amount of time before the bill matures and the prevailing rate of interest for this type of paper. In the United States such bills can be rediscounted at Federal Reserve Banks.

Whether the merchandise will be surrendered to the importer when he accepts the draft, or not until he makes payment, will depend upon whether the arrangements provide for "Documents against acceptance" (written D/A) or "Documents against payment" (D/P). Sometimes the merchandise is placed in a ware-



house and parceled out to the importer a little at a time as he sells the goods and makes payment. The warehouse gives the bank what is known as a warehouse receipt; sometimes banks have their own warehouses. This procedure involves difficulties and is avoided if possible.

### TRUST RECEIPT UNDER COMMERCIAL LETTER OF CREDIT

19

Received, upon the trust hereinafter mentioned, from \_\_\_\_\_  
the following documents and the goods and merchandise represented thereby,  
all the property of the said bank and specified in the bill of lading as follows:

DATE	VESSEL	MARKS AND NOS.	MERCHANDISE

and in consideration thereof, undersigned hereby agrees to hold said goods in trust for said bank and as its property, with authority to sell the same for its account and immediately deliver the proceeds of said sale to said bank, but without authority to make any other disposition whatsoever of said documents or the goods or merchandise represented thereby, or any part thereof or any of the proceeds thereof, either by way of conditional sale, pledge, mortgage, transfer, or otherwise.

In case of sale, the undersigned further agrees immediately to deliver the proceeds as soon as received to the said bank to apply against the \_\_\_\_\_ acceptance \_\_\_\_\_ of \_\_\_\_\_

for \_\_\_\_\_

Dollars (\$ \_\_\_\_\_) under the terms of Commercial Letter of Credit No. \_\_\_\_\_, dated \_\_\_\_\_, issued for the account of the undersigned and for the payment of any other indebtedness of undersigned to said bank.

Undersigned agrees to keep said goods insured to their full value against fire; the sum insured to be payable in case of loss to the said bank or its nominee, with the understanding that said bank is not to be chargeable with the storage, premium of insurance, or any other expense incurred on said goods.

Undersigned further agree that no failure or omission on the part of the undersigned fully to carry out any of the provisions of this or any similar receipt or agreement, or of the agreement under which the said bank issued the Letter of Credit under which said documents and the goods and merchandise represented thereby were purchased, shall be deemed a waiver by the said bank of any of its rights or remedies under either of said agreements, unless said waiver shall be in writing endorsed hereon and signed by the said bank.

The said bank may at any time cancel this trust and take possession of the documents and/or the goods and merchandise represented thereby, or the proceeds of such as may have been sold, wherever said goods or proceeds may then be found; and in the event of any suspension or failure or assignment for the benefit of creditors on the part of the undersigned, or of the nonfulfillment of any obligation, or of the nonpayment at maturity of any acceptance made by undersigned under said credit or under any other credit issued by the said bank on account of the undersigned or any indebtedness of the undersigned to the said bank all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon, with or without notice, mature and become due and payable.

In the event that the value of the documents hereinabove mentioned or of the goods and merchandise represented thereby shall depreciate in value, the undersigned agrees either to pay to said bank in cash the amount of said depreciation or deliver to said bank other documents and/or goods or merchandise represented thereby of the then market value equivalent to said depreciation.

Figure 6. Trust Receipt

If a draft is drawn and sold "without recourse," the exporter is relieved of liability in case of non-payment or other loss. British and American banks, however, usually refuse to discount such bills because of the risk involved. Drafts of this kind are not eligible for rediscount at the Federal Reserve Banks.

**Trust Receipt.**—When the arrangement is that the documents are to be turned over to the importer only against payment, and the importer is unable to pay, the merchandise may be made available to the importer by his bank under an arrangement whereby the importer signs a "trust receipt." The importer thus receives the goods in trust, and does not obtain title to them. The trust receipt provides that the importer shall be the agent of his bank in the sale of the imported goods. The bank retains ownership of the merchandise until the importer has made full settlement, and all sums received from the sale of the goods must be credited to the bank until such settlement is made. Any losses that occur under a trust receipt are borne by the bank and not by the exporter. A common form of trust receipt is shown in the accompanying illustration (Figure 6).

**Bankers' Bills.**—In addition to the commercial bill, referred to above, is the banker's bill, drawn by one bank on another bank. This is a common type of draft for making foreign

THIS CHECK MUST BE PRESENTED FOR PAYMENT WITHIN A REASONABLE TIME AFTER DATE OF ISSUE. OVERPAID OR CASHED CHECKS WILL BE RETURNED TO THE ISSUING BANK.

**Bank of America** No. 000000  
NATIONAL TRUST SAVINGS ASSOCIATION

*California-Montgomery Branch, San Francisco, January Second, 1943*  
(BRANCH) (DATE)

PAY FROM OUR BALANCE AGAINST THIS ORIGINAL CHECK (DUPLICATE UNPAID)

TO THE ORDER OF *Peter J. Montgomery*

*Two Hundred and Fifty Thousand Francs*

To *Credit Lyonnais*

At *Paris, France*

PRINTED IN UNITED STATES OF AMERICA

**Bank of America**  
NATIONAL TRUST SAVINGS ASSOCIATION

MANAGER / ASST. MANAGER / ASST. CASHIER

Figure 7. Banker's Bill

remittances. Banker's bills are used when an individual or corporation in one country desires to remit, for whatever purpose, to someone in a foreign country. A frequent use of this type of bill is where an importer goes to his bank and has it draw a draft on a bank in the exporter's country and payable to the exporter. The importer pays for this bill which he then sends to the exporter, who cashes it at his own bank.

When a bank draws upon a foreign bank, it, of course, has an account in such foreign bank, or arrangements whereby drafts can be drawn on it. Banks have arrangements whereby they can draw drafts on some bank in practically every im-

HEAD OFFICE SECURITY-FIRST NATIONAL BANK OF LOS ANGELES LOS ANGELES, CALIFORNIA U. S. A. PRINTED IN U. S. A.	N <sup>o</sup> 188252		ORIGINAL CHEQUE FOR Pesos 50,000
	ISSUED BY <u>First National Office</u> BRANCH <u>January 3, 1943</u>		
	PAY AGAINST THIS CHEQUE FROM OUR CREDIT BALANCE TO		
	<u>John Doe</u> D U P L I C A T E B E I N G U N P A I D OR ORDER		
	THE SUM OF <u>****Fifty thousand pesos****</u>		
To <u>National City Bank</u>		<div style="font-size: 4em; opacity: 0.5; transform: rotate(-15deg);">VOID</div>	
<u>Buenos Aires</u>			
<u>Argentine Republic</u> (Signed) _____			

Figure 8. Another Form of Banker's Bill

portant city of the world. Two samples of bankers' bills are shown in the accompanying illustrations. In the first instance, Figure 7, the Bank of America in San Francisco has drawn on the Credit Lyonnais in Paris for 250,000 francs payable to the order of Peter J. Montgomery. In the second instance, Figure 8, the Security First National Bank of Los Angeles has drawn on the National City Bank in Buenos Aires for 50,000 pesos payable to the order of John Doe.

**Bankers' Acceptances.**—When an exporter draws a draft on a bank, the draft, after being accepted by the bank, is known as a "bank acceptance," or "banker's acceptance." Such drafts are usually drawn by exporters on the bank of the importer under a letter of credit provided by the importer, as discussed

The accompanying illustration, Figure 9, shows a banker's acceptance. It is drawn by the Jackson Sugar Company of

Figure 9. Banker's Acceptance

Havana payable to itself 90 days after sight, on the Security First National Bank of Los Angeles. The bank has accepted the draft, and thereby fixed the due date. The bank must now pay the draft when due, regardless of whether the Jackson Sugar Company is paid by the American importer of the sugar, or of what may happen to the Jackson Sugar Company.

**Drafts for Collection.**—When a bank does not wish to buy or discount an exporter's bill of exchange, it may act as collecting agent. The bill is then forwarded to a foreign correspondent bank which presents it to the importer for payment or acceptance. Where drafts are placed for collection, banks generally provide a blank form covering the most important points of instructions so that the exporter's interests will be protected. Charges for collection usually vary from  $\frac{1}{8}$  to  $\frac{1}{4}$  of 1%.

**Usance of Drafts.**—The length of time a bill of exchange has to run before payment is known as its "usance" or "tenor." "Sight drafts" are those payable immediately upon presentation to the drawee. They are the same as "demand drafts," referred to by the letters D.D. "Time drafts," as their name indicates, run for various periods of time; for example, 60 or 90 days.

The date of payment is usually contingent upon the time when the bill is presented to the drawee. Since time drafts usually do not begin to run until accepted by the drawee, they are presented promptly for acceptance, which thus fixes their maturity. A bill may read "90 days after date," or "30 days after sight," or "60 days after acceptance"; or the draft may provide, as a concession to the importer, that it is "not payable until after arrival of merchandise." A so-called arrival draft of this type often results in confusion, since there is sometimes debate over what is meant by arrival when delivery at the port of entry is delayed. "Long bills" are time drafts drawn for longer than 30 days, while "short bills" are considered as those running for 30 days or less. Few bills are drawn for more than 90 days, except in South American trade.

Cables, or telegraphic transfers, referred to by the letters T.T., are where a bank telegraphs a foreign bank to pay a cer-

tain amount of money to a designated payee. In this way immediate transfer of funds may be accomplished.

**Documentary Drafts.**—Documents which usually accompany a draft include the commercial invoice, the bill of lading, and the marine insurance policy or certificate. In addition to these documents, certain others are usually required, such as the consular invoice, the hypothecation certificate, and the certificate of origin. The invoice is the description of the merchandise which the exporter makes for his customer, and also for the government. The bill of lading constitutes both a receipt from the shipping agency and a means of conveying title. The insurance certificate protects the shipment against possible loss or damage *en route*, usually from warehouse to warehouse. The hypothecation certificate is a legal instrument giving the holder of the draft power to sell the merchandise for what it will bring in the event of non-payment by the importer, and also to recover from the exporter any losses that may occur. The documents, including the draft, are made out in duplicate (three copies generally being made of the bill of lading), and a complete set of each is often mailed on different ships to insure arrival of the draft at its destination.

Drafts which are unaccompanied by documents are known as "clean drafts." Such bills are much less attractive from the standpoint of security than "documentary drafts," and banks generally refuse to buy or discount them. Consequently, in international trade the documentary draft is used almost exclusively, since the documents, when properly executed, give control over the shipment and make it readily possible to transfer title to the goods.

**The Price of Bills.**—Factors which determine the rate of exchange are discussed in other chapters. In a free market these factors have to do immediately with the demand and supply of bills, which in turn are the result of such fundamental considerations as reciprocal demand for goods and services, capital movements, and many other matters. Apart from these determining considerations which apply to all bills, the prices of the different kinds of bills are not the same.

Sight drafts, other things being equal, are worth more than time drafts, because of the loss of interest on time drafts. The value of a bill thus tends to vary inversely with the length of time it has to run. If payment by the importer is to be made by time drafts, exporters, in quoting their prices, ordinarily make allowance for the greater discount charged by banks on time drafts. Thus the terms of financing influence the prices at which exporters are willing to sell their goods.

The credit standing of the drawer and of the drawee also influence the price which a bank will pay for a draft. An exporter who has a good reputation of long standing and who enjoys intimate connections with his bank can always obtain more for the bills he draws than can someone who is not well known. Likewise, a draft drawn on an importing firm of unquestioned standing will secure a more favorable price than one drawn on an importer whose reputation is not established. If the exporter's bill is drawn on a bank, under a letter of credit, its value is still greater.

Another important factor is the currency in which a bill is drawn. Drafts drawn in currencies for which there is little demand may have to be sold at an unfavorable discount. Some currencies are more unstable than others and therefore involve more risk, which harms the selling price of drafts in such a currency. Another factor is the nature and degree of security afforded by the documents attached to the draft, a factor sometimes responsible for considerable price variation. The control of exchange rates by governments or their central banks has made the price of bills in many cases somewhat artificial although the above factors are still present. The effect of the condition of the money market upon the price of drafts is considered in a later chapter.

## CHAPTER 20

### FINANCING FOREIGN TRADE: LETTERS OF CREDIT AND OTHER FACILITIES

**The Commercial Letter of Credit.**—The ordinary commercial draft, discussed in the preceding chapter, provides no assurance that the importer will accept or pay the draft, or that he will take the goods sent to him. Consequently, exporters commonly require the protection afforded by the commercial letter of credit, an instrument now almost universally used in international trade.

A letter of credit is a document containing the guaranty of a bank to honor drafts drawn on it by an exporter, under certain conditions and up to certain amounts. Instead of being drawn on the importer, the draft is drawn on the importer's bank, which has agreed to act for him. The credit of a bank is ordinarily much higher than that of an importer, and the letter of credit provides a means of substituting the bank's credit for that of the importer.

A letter of credit eliminates much of the risk for the exporter, since he knows he will be paid for his shipment provided, of course, he follows instructions. Furthermore, he can dispose of drafts drawn under a letter of credit at the best prices available. He, therefore, ordinarily requests the importer to provide him with a letter of credit. If the importer is not located in a well-known financial center, he will arrange through his local bank for a letter of credit on some large bank to be sent to the exporter. The draft which the exporter draws under a letter of credit is supported by documents as in the previous case.

**Shipments under Letter of Credit.**—As an illustration of a transaction involving a letter of credit, let us assume a ship-



ment of peanuts from Shanghai to San Francisco, payment to be made to the Chinese exporter in American dollars. In the preliminary correspondence, the exporter and importer have made arrangements with regard to the various details for the sale, including the tenor or usance of the draft to be drawn, 90 days' sight, and provision for the opening of an irrevocable letter of credit in favor of the Chinese exporter.

The American importer goes to his bank in San Francisco and fills out a formal application requesting the bank to open the desired letter. In this application he states the terms of sale which have been agreed upon, indicating the documents to accompany the draft, the tenor of the draft, the latest date of shipment, and other details. Banks do not desire too much detail regarding the description of the merchandise, since this opens the door for dispute. If the bank decides to arrange for the credit the importer then signs the letter-of-credit contract, in which he promises to reimburse the bank for all outlays and to give such security as the bank may demand.

The bank thereupon notifies its correspondent in Shanghai, requesting it to confirm the credit to the peanut exporter. The Shanghai bank informs the exporter that an irrevocable and confirmed letter of credit has been arranged, and describes the terms under which shipment must be made before the draft will be honored. The contract is now binding on both the San Francisco bank and the Shanghai bank.

The Chinese puts his peanuts on board a ship bound for San Francisco, preparing all documents as specified by the letter of credit. He draws his draft, a 90-day bill as previously arranged, and goes to his own bank in Shanghai and sells it. The draft being in American dollars is drawn against the San Francisco bank. The Shanghai bank that buys the draft pays the exporter in Chinese dollars according to its current buying rate for drafts of this type. The exporter has now shipped his peanuts, drawn his draft, and received his money. He drops out of the picture.

The draft and accompanying documents are then sent by the Shanghai bank to some San Francisco bank other than the one on which the draft is drawn and which issued the letter of credit. Upon arrival in San Francisco the draft is presented by the

bank receiving it to the bank on which it is drawn to have it accepted. The draft now becomes a bank acceptance, and is retained by the bank presenting it. The accepting bank, however, is now entitled to the documents, in view of its acceptance, and takes possession of these, turning them over to the importer, perhaps against a trust receipt, so that he can receive the peanuts. If the Shanghai bank wishes to be reimbursed immediately, it instructs the bank in San Francisco to which it sent the draft to discount it in the open market and remit the proceeds, or to deposit them to the Shanghai bank's account in San Francisco, so that the Shanghai bank can draw drafts against this money. If it is in no hurry for the money, it may wait the 90 days and receive the interest involved.

It can be seen that the commercial letter of credit has a number of advantages both to exporter and importer. For the exporter the credit risk is virtually eliminated. He need not worry about the credit of his customer, since the draft is drawn not on the customer but on a bank—often a bank in the exporter's own country. Consequently, the exporter's draft can be sold or discounted at the most favorable terms. While most of the responsibility is placed on the importer, a letter of credit is not without its advantages for him, since he can then secure the best prices from the exporter, and can rest assured that the shipment will be made not later than the date stipulated in the letter of credit, and that no payment will be made until shipping documents have been surrendered by the exporter.

**Types of Letters of Credit.**—Letters of credit are of many kinds. A "cash," or "straight," letter of credit is one which authorizes the exporter to draw a sight draft on a certain bank, while an "acceptance" credit permits him to draw a time draft, which the bank accepts. The bank acceptance can, of course, easily be sold or discounted if the money is desired immediately.

An "irrevocable letter of credit, confirmed" is the type dealt with in the preceding illustrations, and is sometimes insisted upon by exporters. It represents the unconditional guaranty of both the opening and confirming banks that the exporter's draft will be honored under the conditions specified. This form offers

the greatest degree of protection to the exporter. The "irrevocable letter of credit, unconfirmed," widely used, represents the unconditional guaranty only of the issuing bank that the draft will be paid or accepted. The value of such a letter, of course, depends upon the standing of the opening bank.

A "revocable" credit may be cancelled by the bank at any time, and hence is hardly worthy of classification as a letter of credit. Some banks refuse to issue them, since sudden cancellations often result in disputes and litigation. Such letters are now rarely used.

A "revolving" credit allows a number of transactions to be made with the same letter. This is the most convenient way of handling small shipments made at frequent intervals, much delay and expense being avoided. Often the letter is issued for a specific amount available monthly over a continuing number of months—usually six.

An instrument somewhat similar to, but not to be confused with, the letter of credit is the "authority to purchase" (A/P). Originating in the Far East it is now used chiefly by Chinese importers. The importer arranges for the authority to purchase with his local bank, which then notifies its foreign correspondent that it (the correspondent) is authorized to buy the exporter's draft under conditions stipulated. The draft is drawn not on the bank but on the importer, who agrees to honor it and to reimburse his bank for such advances as it may make in connection with the draft.

Generally speaking, the authority to purchase is not looked upon with favor by exporters, since it provides no guaranty of payment on the part of anyone except the importer, when he accepts the draft. The exporter endorses the draft when he sells it to the bank, and may find the draft back on his hands unpaid. An authority to purchase specifically states that it is not a bank credit and that the issuing bank may at any time, without prior notice, decline to negotiate any bills thereunder presented to it.

Another instrument is the "authority to pay," which is now used by some banks in place of the revocable letter of credit. This is issued by the importer's bank, and simply states that

drafts may be presented to it for acceptance or payment, with no guaranty, however, that they will be honored. The form advises the seller that it is for guidance in preparing documents. It does not pretend to be a commercial credit, although in practice it is somewhat similar. The "authority to pay" is generally regarded as of little value, unless it is "irrevocable without recourse," in which case it is as good as a letter of credit.

**Risk of Exchange; Forward Exchange.**—In their financing arrangements exporters and importers usually endeavor to eliminate the risk that comes from exchange rate fluctuations. For example, an exporter who is to receive 10,000 pesetas 90 days from date does not know what these pesetas will yield him in dollars at that time. He, therefore, arranges now as to the conversion of these future pesetas into a fixed number of dollars.

When an exporter draws a draft in his own currency, the exchange risk is, of course, with the importer, who then must buy a draft on the exporter's country to cover the draft drawn by the exporter. When an exporter agrees that the draft be in a foreign currency, he then either bears the exchange risk himself, or must arrange to avoid it. If he wishes to avoid this risk, he can make what is called a future contract, that is, arrange with his bank ahead of time as to the price the bank will pay for the kind of draft he is to draw. He then knows exactly what he will receive in his own kind of money for the draft he will have to sell. This is called "fixing exchange forward."

Exporters often insist that the letter of credit be drawn in the currency of their own country, so as to eliminate the exchange risk. American exporters commonly express price quotations in terms of dollars, and specify dollar payment, while English exporters commonly insist upon payment in pounds. If an American exporter asks that the letter of credit be in dollars, he draws his bill not on the foreign bank opening the credit but on the confirming bank in America.

When a bank buys a foreign draft, if it does not wish to take a position in the currency in question, it will immediately sell an equal amount of exchange, so as to cover the draft it

has purchased. For example, the exporter sells to his bank a draft for 10,000 francs due 90 days from date. At the same time an American importer of French goods knows that in 90 days he must buy a draft for 10,000 francs to cover a shipment he is receiving. He is uncertain as to what the draft may cost him in the future because of exchange fluctuations. To avoid the risk, he arranges with his bank now as to the price to be paid. The bank thus arranges to sell him the francs it buys from the American exporter. The bank then does not care what happens to French exchange. It has covered a purchase with a sale and assumes no risk of exchange. The maturities of the drafts are not of vital importance in hedging operations of this kind. The sale of a demand draft by a bank can be covered by the purchase of a 60- or 90-day draft.

Speculators who think the price of a foreign currency is too low may buy that currency with the hope of re-selling at a profit later. Or if they think it too high, may sell it short, expecting to cover their sale by a subsequent purchase at a lower price. Speculators deliberately assume a risk which most foreign traders are glad to avoid.

In the case of countries with rapidly fluctuating currencies, or perhaps not well-known currencies, letters of credit are often expressed in neither the currency of the buyer nor of the seller, but in terms of the currency of a third country. Prior to the first World War, this third country was usually Great Britain. Even American foreign trade was generally financed in terms of British pounds sterling. After the war, however, the American dollar came to be widely used all over the world. In cases where the currency of a third country is utilized, the letter of credit is issued by a bank in the importer's country, as before, but is confirmed by a bank not in the exporter's country but in the third country. The exporter thus draws his draft on the confirming bank.

An example will make this clear. A Brazilian importer of tobacco from Egypt might arrange through his local bank for some London bank to issue a letter of credit to the Egyptian exporter, the credit being in British pounds. The tobacco exporter would then draw his draft on London, sell it to his own

bank in Cairo, which would forward the draft to its London correspondent to have it presented to the bank in London on which it was drawn for acceptance. The accepting bank would detach the documents and send them to Brazil, so that the importer could receive his tobacco. As the date of maturity of the draft approached, the Brazilian importer would be asked by his local bank to supply it with a draft on London to be sent to the accepting bank there for covering the draft about to fall due.

**The Edge Act.**—To assist this country's expanding foreign trade and strengthen the position of the United States in international finance, the so-called Edge Act was passed in 1919 as an amendment to the Federal Reserve Act.<sup>1</sup> The war had suddenly brought this country to the fore in the field of international finance, and there was a desire to encourage this development. The Edge Act provided for the establishment of large banking institutions devoted exclusively to foreign financial operations.<sup>2</sup>

Banks chartered under this law may be of two kinds. One of these engages in the ordinary activities associated with the financing of foreign trade, such as buying and selling exchange, issuing of letters of credit, and handling collections. Such banks are permitted to accept drafts up to ten times their capital and surplus, whereas national banks may accept drafts only up to an amount not exceeding their capitalization. This first type of bank is much like the foreign department of a commercial bank.

The other type of so-called Edge bank is concerned with foreign investment. It buys foreign bonds, mortgages, and other securities, and against these issues its own notes and bonds which are sold to Americans. It thus resembles an investment trust. The law prohibits either type of bank from assuming the functions of the other. Furthermore, Edge banks are not

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<sup>1</sup> Section 25(a).

<sup>2</sup> The law stipulated that these banks were to have a minimum capital and surplus of \$2,000,000 and that the greater part of the stock in each bank was to be held by American citizens. The boards of directors were to be composed entirely of Americans, and all banks created under this act were to be under the supervision of the Federal Reserve Board.

permitted to engage in domestic operations or accept domestic deposits, except as necessary in the performance of their foreign functions.

The Edge Act has been somewhat disappointing in that only four institutions have been created under it, and three of these have passed out of existence. The only institution of this type in active operation at the present time is the Chase Bank, an affiliate of the Chase National Bank of New York. The Chase Bank, which has its head office in New York City, also operates branches in Paris, Hong Kong, Shanghai, and Tientsin, China.<sup>3</sup>

**Webb-Pomerene Associations.**—In April, 1918, the Webb-Pomerene Act was adopted, the purpose being to assist American businesses engaged in foreign trade in meeting the competition offered by large foreign monopolies or cartels. American foreign trade had been stimulated by the war, and the Act was passed in anticipation of the active competition for markets which was expected in the post-war period.

According to federal anti-trust legislation, American businesses are not allowed to combine or engage in practices which might be construed as monopolistic or in restraint of trade. Prior to the above law, these prohibitions applied to foreign as well as to domestic trade. In order to enable American businesses to compete abroad on equal terms with large foreign combinations, the Webb-Pomerene Act permits American businesses to combine into cooperative selling organizations in connection with foreign sales. Exporters are allowed by this law to form associations, under the general supervision of the Federal Trade Commission, without violating by this action anti-trust laws. A large number of such export associations have been formed and are in active operation.

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<sup>3</sup> Three other institutions have operated in the past under the Edge Act, but subsequently liquidated their affairs. The First Federal Foreign Banking Corporation of New York commenced business in 1920 and operated for several years thereafter. The Federal International Banking Corporation of New Orleans commenced operations in 1921 and was in business for several years. The First Federal Foreign Investment Trust of New York, which began its operations in 1926, changed its corporate title to the First Federal Foreign Banking Corporation in 1928, and was placed in liquidation by vote of its shareholders in 1933. Data supplied by Federal Reserve Board.

**United States Export-Import Bank.**—In order to provide more adequate facilities for the financing of foreign trade, two special government Export-Import Banks were created in 1934. The capital of these banks was subscribed entirely by the United States Government. The Export-Import Bank of Washington was established to take care of credits arising from American trade with Russia, following recognition of the Soviet Union by the United States. The second Export-Import Bank was created to extend credits to the Republic of Cuba. It soon expanded its operations, however, to include all countries except the Soviet Union. These two banks were established particularly for the purpose of supplementing existing private credit facilities rather than competing with them.

The first Export-Import Bank decided not to finance trade with Soviet Russia until a satisfactory settlement had been made regarding the debts and claims between the United States and the Soviet Union. After the debt negotiations broke down in 1935, the second Export-Import Bank gradually withdrew and transferred its affairs to the first Export-Import Bank, which never financed any trade with Russia.<sup>4</sup>

The present bank in its annual report for 1936 described its operations as falling in three fields. First, it extends 90-day credits in connection with the export of agricultural products, especially cotton and tobacco, when facilities are not available from private institutions. Longer credits have been made when the bank felt they were desirable. Second, the bank grants credits to firms desiring to export industrial products, particularly heavy machinery and railway equipment. These credits run from about one to five years, since foreign competitors have credit facilities of this nature. Third, the bank extends credits to exporters who have been unable to realize on funds owing them from abroad because of exchange restrictions and the inability of foreigners to obtain sufficient exchange to meet their dollar obligations. The bank has also bought from other governmental agencies various obligations owing these agencies

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<sup>4</sup> The preferred stock of this bank is owned by the Reconstruction Finance Corporation, while the common stock is held by the Government in the name of the Secretary of State and the Secretary of Commerce. Annual Report of Export-Import Bank of Washington, 1936.



by foreign countries. On March 15, 1942 the bank had loans outstanding totaling \$45,000,000 and undisbursed commitments of \$344,000,000. In October, 1941 the bank announced that it was ready to underwrite short-term credits, for financing American exports, opened by American banks at the request of Latin American commercial banks, under certain conditions.

The bank has made a great many loans and commitments, particularly in Latin America, that have to do with the United States foreign policy. These activities of the bank are discussed in Chapter 33 on American Foreign Economic Policy.

**Foreign Branch Banks and Foreign Correspondents.**—In order to handle foreign business, banks either maintain their own branches abroad or deal with banks already established there. Foreign banks with which working arrangements are maintained are known as correspondent banks. A foreign branch, as the term implies, is an integral part of the domestic institution. A correspondent, on the other hand, is a separate foreign institution which performs certain services for the domestic bank.

British banks maintain numerous branches in Great Britain, but few branches in foreign countries. Great Britain has long relied largely on foreign correspondents, affiliated institutions, and British-owned overseas banks which usually maintain their head offices in London. Banks in the United States have depended much more on correspondents than on foreign branches. Most American banks until recent years have been prevented by law from having branches even within the United States. It is thus logical that American banks should have turned to foreign correspondents. Only since 1914 have American banks established many foreign branches. American banks which maintain extensive systems of branch banks abroad are, in order, the National City Bank and the Chase National Bank, both of New York, the First National Bank of Boston, and the Guaranty Trust Company of New York.

Prior to the Federal Reserve Act of 1913, national banks were not allowed to have branches, so that American banks with branches abroad in 1913 were mainly trust companies and pri-

vate banking institutions. There were, in addition, two independent foreign banking corporations, making a total of ten American institutions operating 32 banking offices abroad. The foreign offices of these ten institutions were distributed geographically as follows: Europe, 41%; Asia, Oceania, and Africa, 37%; Latin America 22%.

By 1920, as a result of the war which thrust America into the international field, and the post-war boom, there were sixteen institutions with 224 banking offices abroad. By 1926 the number had declined to twelve with 159 offices, and by 1933 to eight but with 223 offices. In June, 1939, just prior to the outbreak of war, there were ten American financial institutions with 174 banking offices in twenty-nine countries. Of the ten institutions, four were national banks, four were trust companies, and two were private banks. The geographic distribution of these offices was as follows:

AMERICAN BANKING OFFICES ABROAD, JUNE 30, 1939<sup>5</sup>

EUROPE		LATIN AMERICA		ASIA AND OTHER	
Belgium .....	5	Argentina .....	9	China .....	12
England .....	20	Brazil .....	4	India .....	6
France .....	12	Chile .....	2	Japan .....	4
Germany .....	3	Colombia .....	3	Other .....	5
Italy .....	35	Cuba .....	18		—
Switzerland .....	4	Dominican			27
Other .....	7	Republic .....	6		
	—	Mexico .....	1		
	86	Panama and Canal			
		Zone .....	8		
		Puerto Rico .....	7		
		Other .....	3		
			—		
			61		

The existence of branch banks in foreign countries is helpful to the foreign trade of the country, since it facilitates and simplifies transactions and provides for the interchange of credit information. New business is often developed through the instrumentality of branch banks.

<sup>5</sup> Clyde William Phelps, "Trends in American Banking Abroad," *Banking*, December, 1937; also unpublished manuscript by same author.

**International Financial Centers.**—Ordinarily, foreign trade is financed through one of the large international financial centers—particularly London or New York, and to a lesser extent Paris, Berlin, and Amsterdam. Four factors that affect the importance of a financial center are: (1) the banking, credit, and other facilities which exist there, (2) the connections between the foreign traders and the financial center that have been built up over the years, and that are often the result of political, geographic or trade ties, (3) the rate of discount on bank and trade acceptances prevailing in the various centers, and (4) the degree of political and also currency and exchange stability that exist.

Banking connections, credit facilities, and custom play an important part in determining the centers through which international trade is financed. These account in substantial measure for the traditional supremacy of London in this respect. London has long been well equipped to finance foreign trade, and has banking connections all over the world. Foreign traders are acquainted with London and the facilities existing there.

The manner in which the acceptance rate affects the choice of a financial center in any particular transaction is not difficult to understand. An exporter's draft, when sold after acceptance (either by a bank or customer), is discounted at the prevailing rate of interest on acceptances—that is, the amount of interest for the period to maturity is deducted from the face value of the bill. If the acceptance rate is low in London and high in New York, a Brazilian exporter of coffee to Sweden, let us say, quite obviously can sell his draft for more money if it is drawn on London than if drawn on New York, other things being equal. When it comes to be discounted in London, less will be deducted than would be the case in New York. Consequently, he is likely to have it arranged that he is to draw a draft, payable in pounds, on a London bank.

The interaction of international financial forces tends constantly, when political and economic conditions are relatively stable, to equalize acceptance rates in the various centers, but differences exist. Central banking policies contribute to such differences.

A country that has fluctuating or uncertain exchange rates is at a disadvantage. An exporter cannot figure accurately very far ahead how much a foreign bill will yield him in his own currency. If he quotes prices and sells in terms of his own currency, then the importer cannot figure accurately how much the goods will cost him. Furthermore, deposit balances maintained in such a center may depreciate in value. The threat of governmental restrictions on the purchase and sale of bills is likewise damaging. Consequently, a financial center may decline rapidly in importance if the country in which it is located becomes politically unstable so that its currency does not command the confidence of foreigners.

**London and New York as Financial Centers.**—The two leading financial centers of the world are New York and London, each quietly assuming that it is more important than the other. Both of these cities have large financial institutions equipped with extensive facilities for the financing of foreign trade and other financial dealings. Both cities have a broad market for foreign bills, a broad discount market as it is called. The owner of a time bill who does not wish to hold it to maturity thus finds a ready market where it can be sold or discounted. The war has, of course, greatly affected the activities of these financial centers.

The pound and the American dollar are currency units known all over the world, so that a draft on New York or a draft on London is acceptable anywhere. A draft on a less known center could, of course, be sold in most cities; but inasmuch as the market for such a bill is narrow, the rate might not be as favorable as if the draft were in terms of one or the other of these two leading currencies. As already mentioned, pounds and dollars are often used even in the case of trade between countries other than the United States or Great Britain. Furthermore, most banks that do much foreign-exchange business maintain balances in New York and London, and deal regularly in pounds and dollars. They are always ready to buy or sell these currencies. Thus it is that these two currencies have become almost international money. Francs, marks, lire,

yen, guilders, and certain other currencies are also well known in foreign-exchange channels, and in some cases are better known than pounds and dollars. In general, however, this is not so. American paper money has been carried abroad by tourists, and imported by foreigners for hoarding, so that in any large city of the world the hotels and leading stores will accept it without hesitation and will often be able to make change in American paper, but not in American silver.<sup>6</sup>

Prior to 1914, the dollar was little used in foreign trade transactions, and New York was not an international financial center in a genuine sense. Changes introduced into American banking by the Federal Reserve System in 1914, together with business which came to America as a result of the war and of the post-war disturbances in Europe, developed New York in the space of a few years into a financial center rivaling if not surpassing London. In the period after the first World War, when European currencies were chaotic, the dollar was practically the only stable, reliable gold-standard unit, and the United States was regarded as a country removed from the distress and uncertainty of Europe.

During the nineteen twenties, large international loans were floated in New York, and contributed to the financial leadership of America. It is true that many of these loans were unsound and should never have been negotiated, as subsequent experience showed. Nevertheless, New York established itself as a capital market and a leading financial center.

When Great Britain returned to gold in 1925 and the pound became redeemable in gold, London regained much of the ground lost to New York as a result of the war. Then when Great Britain left gold in September, 1931, the prestige of the pound suffered, and the position of London in international finance was shaken. Banks that maintained balances in London lost heavily when they were unable to withdraw their funds in gold, and had to accept large discounts because the pound became depreciated. Several central banks had come to maintain part

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<sup>6</sup> As a result of the sale, especially in Latin America, of American currency looted by the Axis powers from occupied countries, restrictions imposed on the purchase of American money have caused it to depreciate abroad.

of their reserves in the form of deposits in London and New York. Thus it was that when Great Britain left gold, other countries, unable to get their reserves in gold, were compelled also to leave gold. These events seriously weakened London, but helped the prestige of the American dollar.

In 1933, however, the new administration in the United States decided to leave gold, and this was done in April of that year. The French franc, the leading gold unit remaining at that time, rapidly gained prestige; but confidence in the franc weakened as it became clear that the franc would have to be devalued. The widespread currency and exchange disturbances made banks suspicious of all foreign currencies. The lack of reliable international currency units handicapped foreign trade and financial dealings.

As the leading currency units again became more stable, or less unstable, particularly after the devaluations of the former so-called gold-bloc currencies and the currency agreement between France, the United States, and Great Britain in October, 1936, confidence in currencies increased. The period, however, was one of increasing restrictions on foreign-exchange dealings, the blocking of funds (i.e., preventing their transfer), and the inauguration of exchange control, especially on the continent of Europe, wherein foreign bills could be purchased only by license—granted only for goods considered necessary—together with quotas, clearing agreements, and various other governmental regulations. These altered very greatly the technique and machinery for conducting foreign trade. Then came the war and further governmental control over trade. New York and London still continue, however, as the world's major financial centers.

## CHAPTER 21

### INTERNATIONAL MONEY MARKETS

**Nature of International Money Markets.**—The term *money market* refers to a financial center in which funds are constantly being lent and borrowed, particularly short-term funds. Closely allied with the short-term market is the long-term capital market. The organization and methods of the long-term market differ greatly from those of the short-term market.<sup>1</sup> In the short-term market the types of instruments commonly bought and sold, or discounted, are principally bankers' acceptances, trade acceptances, commercial paper (i.e., promissory notes sold in the open market),<sup>2</sup> foreign bills, call loans to brokers, and United States Treasury bills and certificates.

Money markets serve wide areas, and an international money market is one in which a large portion of the transactions involve foreign funds and currencies, a market where foreign bills are regularly bought and sold. London and New York are the outstanding international money markets, while lesser European centers include Paris, Amsterdam, Berlin, and Zurich.

Funds are attracted to financial centers from near and far, and are lent there to a wide variety of borrowers. The money market thus acts as a reservoir into which come funds for lending, including funds that may not be needed for the time being, and from which they are directed into channels which bid for them.

The stock market is often referred to as a delicate indicator of domestic economic conditions; so the international money

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<sup>1</sup> Short-term transactions are generally considered as those involving a time element of not more than one year. "Short bills," however, are those running not over 30 days.

<sup>2</sup> The borrower, instead of borrowing from his bank, sells his note to a commercial paper house or dealer, who thereupon sells the paper, usually to a bank with surplus funds.

market is considered a sensitive indicator of world economic and political conditions. This is because it reflects not only the volume of international business transactions and the volume of funds available for financing them, but also reflects current conditions in any particular country. Let a country have a political upheaval, a flood, a major business failure, or be threatened with war, and immediately the currency and securities of that country become depressed in all the international money centers. When Japan, for example, commenced hostilities against China in July, 1937, Japanese bonds declined rapidly in New York and elsewhere. The accumulating evidences of war during these years were continually reflected in the world's money markets.

A money market should be thought of as a rather loosely knit group of specialized markets, each dealing in a different type of short-term investment. These constituent markets are the acceptance market, the commercial-paper market, the short-term Treasury market, and the call-money market. The bank acceptance and the trade acceptance have been discussed in a previous chapter, as has the manner in which they provide a safe and liquid form of investment. The market that deals in this type of paper is called the acceptance, or discount, market. Commercial paper represents the promissory notes of corporations, and has a market of its own in financial centers. Treasury bills are short-term obligations issued by governments in the financing of deficits, and are bought and sold in huge amounts on both the London and New York markets. The call market has to do with money lent for stock market speculation. The money is lent by banks to brokers who loan it to speculators to purchase securities. The money is withdrawable upon call, so that the loans are highly liquid.

The money market, it will be seen, embraces a variety of types of lesser markets, all having to do with short-term lending. They are sometimes referred to as the open market. Money markets differ greatly from country to country in technical arrangements and methods, the differences being due to variations in the economic life and habits of the countries, but the principles involved are essentially the same everywhere.

Money markets are constantly changing with economic con-



ditions. In the years immediately preceding 1930, most of the short-term funds in the New York market were lent on call for stock market speculation. Brokers' loans thus grew to very large amounts. During the subsequent depression and recovery the great bulk of short-term capital was invested in United States Treasury bills. The demand for Treasury bills became so great that the interest yield declined to almost nothing. This condition continued even after the outbreak of war and the entry of the United States into the conflict, in spite of the huge demands of the Treasury for funds. The low rates were in part the result of support of the market by the Federal Reserve System.

**Requisites of an International Money Market.**—Certain conditions are essential for the smooth and effective functioning of an international money market. First and foremost is that of reasonably stable currencies. International lending and borrowing, even on a short-term basis, are greatly hampered when exchange rates are fluctuating erratically or are insecure. Under these conditions, lenders have no way of knowing whether they will be repaid in money equal to that which was lent. If the instability is great, international lending ceases entirely. Formerly, between gold-standard nations, there was little trouble in this regard, since exchange rates varied only within narrow limits, the limits determined by the cost of shipping gold. Since the abandonment of the gold standard, exchange rates between the leading countries have, nevertheless, been kept fairly stable through government control, and by international agreement. The rates, however, are altered from time to time, and inability to have confidence in their permanency interferes with international financial operations.

Another essential is a reasonably free market for foreign exchange. An international money market cannot operate effectively in a country where the purchase and sale of foreign bills is subject to limitations and restrictions. When the supply is parceled out by the government and capital transfers either prohibited or narrowly restricted, as is often the case today, the problem of the foreign lender is not so much whether he will

be able to receive back with interest the full value of what has been loaned, but whether he will be able to withdraw his funds at all. Only when funds can be withdrawn from a foreign country without delay or inconvenience will short-term credits be granted to it and capital flow there on even a small scale.

Another qualification is an adequate and reasonably safe banking system, together with a supply of loanable capital. A nation must have large strong banks and financial institutions, with ample capital resources and extensive foreign connections. Banks of international reputation are needed to sustain an international money market. Most foreign trade transactions involve bankers' acceptances, the value of which is dependent upon the standing of the accepting bank.

Since money markets are exceedingly sensitive to political conditions, governmental stability and political freedom are indispensable for their proper functioning. A country of uncertain political conditions, or with a dictatorial government, does not command the necessary confidence of foreign or domestic business interests. Democratic institutions are essential to healthy financial and economic conditions generally.

#### **The Different Market Rates of Interest Are Related.—**

Each of the individual markets which together comprise a financial center is characterized by a separate interest rate. There is an acceptance rate, a call-money rate, a commercial-paper rate, etc., each rate depending upon the demand and supply of capital for that particular type of transaction. All the rates, however, are closely related, and tend to rise and fall together, since capital can flow freely from one group to another. Thus if the call rate, which is subject to the widest fluctuations, rises, funds are withdrawn from other individual markets, which tends to raise the rates of these and to lower the call rate.

In London, the market rates are vitally influenced by the Bank of England rate, since the Bank of England is always willing to advance funds against eligible paper<sup>3</sup> at its own rate. This fact tends to keep the various market rates in line with the

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<sup>3</sup> To be eligible for discount at the Bank of England, a bill must bear at least two good British names, one of which is the acceptor. Cf. Chapter 38.

Bank of England rate. Ordinarily the Bank rate is highest, with rates on prime bankers' acceptances<sup>4</sup> and Treasury bills intermediate between the Bank rate and the call-money rate. A similar situation prevails, in normal times, in the money markets on the Continent. In New York, market rates are influenced by the discount rate of the Federal Reserve Bank. At times, however, such as when banks are not borrowing from the Federal Reserve Bank, the Federal Reserve rate may have little effect.

As an example of the different rates for different types of paper, the following rates<sup>5</sup> prevailed in New York in August, 1942:

	Per cent per annum
Prime Commercial Paper, 4 to 6 months.....	5½-¾
Prime Bankers' Acceptances, 90 days.....	7/16
Stock Exchange Time Loans, 90 days.....	1.25
Stock Exchange Call Loan Renewals.....	1.00
U. S. Treasury 3-5 Year Taxable Notes (average yield) ..	1.26
U. S. Treasury 3-Month Taxable Bills.....	.369

**Lenders and Borrowers in the Money Market.**—Large commercial banks are ordinarily the leading lending agencies in the money market. Lending, of course, involves not only direct loans by banks to borrowers, but the purchase by banks of various short-term instruments. When a bank buys a Treasury bill it is lending money to the United States Government. The manner in which commercial banks lend or invest their funds in the market varies in different centers. In London, the banks place funds in the money market through purchases of Treasury bills and acceptances, and through direct loans to bill brokers, stock exchange firms, and discount houses. Formerly, banks in the United States placed most of their funds going into the money market in call loans and in commercial paper. Most of such money at present goes into the short-term Treasury and acceptance markets.

Another class of lenders consists of business enterprises with surplus funds. During the American stock market boom of

<sup>4</sup> "Prime bankers' acceptances" are drafts accepted by prominent banks of unquestioned standing.

<sup>5</sup> *Federal Reserve Bulletin*, September, 1942.

1929, corporations placed over four billion dollars at the disposal of commercial banks in New York for lending in their behalf in the call-money market. From April through October of 1929, over half of the New York brokers' loans were from this source. Private individuals also lent large sums in the American call market in 1929, when rates were extremely high. Subsequent legislation prohibited transactions of this kind. In London, the surplus funds of large corporations are often invested in Treasury bills and acceptances.

The central bank of a country frequently places large sums in the money market, through purchases in the open market of certain types of paper. The motive for these so-called "open-market operations" is generally the easing of credit conditions. Conversely, selling such investments tightens the market. Beginning in 1921, the Federal Reserve System has at times made extensive use of this procedure in regulating credit conditions.

Turning to borrowers in the money market, we find that these include a variety of institutions and private individuals. In London, the most prominent borrowers are the bill brokers, who deal in bankers' acceptances and Treasury bills, and the discount houses. In New York, the most important borrowers until the depression were the stock exchange brokers, investment houses, and acceptance dealers. During recent years governments have been the most conspicuous borrowers in nearly all the world's money markets. Short-term financing for deficits has been employed as a means of obtaining funds and of keeping down the long-term funded debt. Short-term interest rates have been lower than long-term rates.

Previous reference has been made to the short-term instruments of the United States Government. Since 1930, transactions in these obligations have overshadowed all others in the New York market. Banks have been particularly heavy buyers. In England, the government after the first World War adopted the policy of issuing every week a certain volume of Treasury bills. This policy affected prevailing rates in the London market in that when the Treasury issued more bills than it redeemed, market rates tended to rise, and vice versa. At the present time the rates are held fairly stable.

The money market, by providing a ready source of liquid capital, has been of great financial help to governments that might otherwise have resorted to the printing press. Treasury bills are bought not only by buyers within the countries of issue, but also by foreign banks and corporations. Many short-term obligations of the United States Government are held by London banks and banks of other countries, while American banks hold British Treasury bills.

In addition to the government, another large borrower in the money market is often the central bank. Central banks appear as borrowers usually for the purpose of tightening credit, as already discussed. They shift from borrowers to lenders according as they wish to ease or tighten credit. They also enter the market to support the price of government obligations. In the middle of 1942 the Federal Reserve Banks commenced buying large amounts of Treasury bills and certificates.

**New York Discount Market.**—The discount, or acceptance market, which deals with bank acceptances and trade acceptances, domestic as well as foreign, is the market through which foreign trade is largely financed. Bills drawn against foreign shipments are constantly being bought and sold here. They are *discounted*, in that the buyer pays less than the face value and receives interest by holding them to maturity. Such bills are very liquid in the sense that they can be sold at any time should the holder desire cash. A broad discount market where foreign bills can be disposed of for cash is thus a necessary part of the machinery for financing foreign trade.

The New York discount market is a recent development, dating from the establishment of the Federal Reserve System in 1914. Only in the period since the first World War has it been a significant part of the New York money market. Prior to 1914, most American banks were not allowed by law to accept time drafts; consequently a discount market could not exist. Most of this country's foreign trade was thus financed in London, and drafts were drawn in pounds on London banks. The growth of the New York discount market was at first a slow and difficult process, since foreign exporters were not eager to

change their financing procedure. They were not always willing to finance shipments through New York in dollars rather than through London in pounds or through some other center. Moreover, considerable time elapsed before American bankers were willing to buy and sell acceptances freely. They were entirely unaccustomed to dealing in such paper, and had to be educated to its use. Gradually, however, these difficulties were overcome, partly through a definite campaign of education on the part of the Federal Reserve System, so that during the twenties a thriving acceptance market developed.

**The Foreign-Exchange Market.**—The financing of foreign trade is a principal function of international money markets. Without the facilities provided by these centers, world trade would be greatly handicapped. During the nineteen twenties the total value of international trade climbed to as high as 62 billion dollars a year. The magnitude of the finance function assumed by the money markets is thus large.

That part of the money market that is immediately concerned with the purchase and sale of foreign bills constitutes what is commonly known as the "exchange market." The most important institutions which make up the foreign-exchange market in New York are the large commercial banks, the private international banking houses, the foreign-exchange brokerage firms, and the acceptance houses.

The foreign departments of the more important commercial banks now handle most of the foreign-exchange business. These departments have numerous correspondents and branch offices at home and abroad, and employ a specially trained personnel. They buy bills of exchange from exporters, and in turn sell to importers their own bills drawn on foreign banks. The drafts which they buy are sent to the proper correspondents, and the proceeds credited to the banks' foreign deposits. These deposits, or balances held abroad, enable the foreign-exchange department to sell its own drafts in the desired amounts, drawn on the proper foreign banks and payable to a designated payee.

Next in importance to the foreign departments of the commercial banks are the private international banking houses,

which formerly held the dominant position in the exchange market. These houses are usually partnerships, and virtually all have long-established reputations. While they have been overshadowed by the commercial banks, the volume of their business is still substantial.

In the buying and selling of foreign exchange, middlemen are inevitable and useful. The foreign-exchange broker, like the foreign-exchange department of a bank, assumes the function of bringing together the various buyers and sellers of foreign bills. By being constantly in touch, directly or indirectly, with buyers and sellers of all types of exchange, the exchange broker can usually save his clients money. Since there is no central gathering place in New York, analogous to the stock exchange, where foreign bills can be bought and sold, dealings with brokers are conducted almost entirely by telephone. Exchange brokers have private wires leading to the offices of the commercial banks, international banking houses, foreign-investment houses, and other buyers and sellers of exchange. It is this close intercommunication between buyers, brokers, and sellers which in normal times keeps rates similar and the market unified.

Drafts drawn by exporters are usually drawn not on the importer but, through letter-of-credit arrangements, on a bank which has agreed to act for the importer, as previously noted. Most international shipments of merchandise thus involve the use of bankers' acceptances. These drafts, of course, may be paid without becoming acceptances, but ordinarily they are accepted and have maturities ranging from 30 to 90 days. These accepted bills are the pieces of paper bought and sold by the discount houses. They form a safe short-term investment.

When these bills are sold in the discount market and held there to maturity, it is the discount market that provides the money which is paid to the exporter as soon as he has shipped his goods and sold his bill. The bank buys the exporter's bill from him for cash, and then may turn around and sell the bill in the discount market, directly or indirectly, thereby reimbursing itself. Thus the discount market helps to finance the exporter.

### **Movement of Funds Between Different Foreign Markets.**

—Under ordinary conditions, the movement of funds between international money markets responds to fluctuations in interest rates and exchange rates. Through interest rates funds tend to be directed to the places where they are most needed, places which bid the highest, and away from those areas where they are not needed. Funds thus tend to go to the highest bidder, who is supposed to be the one who can use the capital most profitably, on the average.

As regards the relative pull of the different money markets for capital, in recent years these tendencies have been submerged by other powerful forces. Capital has fled from a market because of political or economic uncertainty. It has sought other markets considered safer, regardless of interest rates.

When funds are transferred quickly from one financial center to that of another country, all that changes immediately is the ownership of funds. If someone in Switzerland, for example, transfers capital to America, it means that someone in America has given this person in Switzerland title to American dollars, and has received something valuable in exchange, perhaps title to Swiss francs or pounds sterling. Capital transfers, irrespective of purpose, are ordinarily settled through the instrumentality of bankers' drafts or cable transfers, and involve immediately only bookkeeping entries showing changes in ownership. They subsequently lead to a movement of goods or services, unless otherwise cleared.

Between nations on the gold standard, the international shifting of funds sometimes gained such momentum as to raise the price of foreign bills sufficiently above the par of exchange to cause an outflow of gold. Large movements of capital were common during the inter-war period, and put great pressure upon gold reserves and foreign-exchange balances. They were immediately responsible in large measure for the general abandonment of the gold standard and for the serious difficulties confronting the international money markets.

Capital movements during this period were due principally not to oscillations in interest rates, but to extraordinary factors. Mass movements of funds were often occasioned by apprehen-



sion over the stability of certain currencies. Oftentimes the movement resembled a run on a bank. Unfounded rumors that a country was going off the gold standard or was going to depreciate its currency became the occasion for frantic withdrawals of funds. As in the case of bank runs, the withdrawals often made inevitable the events which had been feared—suspension of gold payments or depreciation. Prior to stabilization of the French franc in 1926, French currency difficulties had caused great outflows of capital, represented in large measure by gold, to England, the United States, Switzerland, and Holland. The return of much of this capital and gold to France in the autumn of 1931, partly because of fears regarding the pound sterling following the banking crisis in Austria and Germany in that year, was largely responsible for the abandonment of the gold standard by Great Britain in September, 1931.

Another cause of the sudden capital movements during the inter-war period was not merely the effort to protect funds, but an endeavor to make a profit by speculation on the expected depreciation. Foreign currencies were sold short by exchange dealers and others, just as securities that are expected to decline in price are often sold short. Drafts on a country were sold with the expectation that the currency could be rebought subsequently at a lower rate. The result was to accentuate rather than to counteract the flights of capital, and to cause a dumping on foreign-exchange markets of the weak currency in question.

As the international political situation became more threatening and as war came continually closer, capital movements represented funds that were seeking safety. The flow was particularly to the United States, and was in large measure responsible for the great influx of gold.

Whether the result of panic, speculation, political or economic difficulties, flights of capital are greatly disturbing to foreign exchange and to international money markets. They seriously interfere with the conduct of foreign trade.

## CHAPTER 22

### FOREIGN LOANS AND INVESTMENTS

**Capital Movements.**—International borrowing and lending dates back for many years. In modern times foreign lending and investment have played an increasingly vital part in the development of resources and in international affairs generally. Capital movements across borders have become continually larger. The older, established countries have usually been the lenders, or entrepreneurs, and have sought the newer, undeveloped parts of the world for the investment of funds which could not be used as profitably at home. The industrial development of the United States, until about 1900, was financed to a large extent by European capital. Particularly was this the case as regards railroad construction.

Since the beginning of the first World War, in 1914, movements of capital between countries have assumed large proportions. First were the large inter-government loans during the war. These were made principally by France, Great Britain, and the United States. Then came reparation payments, and other post-war capital transfers, including the private loans for rehabilitation and political purposes, such as the loans extended to Germany in connection with the Dawes Plan. During the twenties, American citizens loaned large sums abroad for investment reasons, principally to Europe and Latin America. The United States went to the extreme in investing its capital abroad, and many of these loans turned out badly.

Due to the almost continuously disturbed conditions throughout the world during the inter-war period, capital moved from country to country seeking safety. Capital came to the United States during the early twenties because of the currency depreciation in Europe. It later came to this country for speculation in American securities. As a result of the depression and the re-

sultant economic disturbances, capital fled first from Europe to the United States, and then from the United States back to those European countries which clung to the gold standard. As economic conditions in the United States improved, capital again came to America, the flow becoming very large in 1936 and continuing until after the collapse of France when war and governmental regulations interfered. The main cause of these capital movements, it will be noted, was not investment but efforts to avoid economic disturbances, high taxes, war, and the restrictions of governments.

Movements of capital during this twenty-year period became so large and often took place so suddenly, that they had profound effects not only upon exchange rates, but upon internal currency, banking, and general economic conditions. The large and sudden capital transfers imposed a heavy burden upon currency reserves (gold and foreign-exchange balances), and resulted in collapse, as in the case of the pound sterling in 1931,<sup>1</sup> or in the adoption of exchange control systems.

**Nature of Capital Transfers.**—Physical currency seldom crosses a border since it would not be current in a foreign country.<sup>2</sup> Gold currency, of course, is an exception. When capital is transferred quickly, often by cable or a piece of paper, the question arises as to just what it is that moves. We noted previously that capital could be transferred only by the movement of merchandise, the precious metals, or the rendering of services. Yet we speak of transferring capital by wire, or by mail. When huge sums are transferred in a short space of time, gold or merchandise have not had a chance to move nor could services be rendered.

The question of capital movements is confused by the fact that the word capital is commonly used with different meanings. First, it is used in the sense of physical wealth—steel, wheat, lumber, machinery, etc.—and second, in the sense of money or other claims to wealth—ownership of the physical wealth or

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<sup>1</sup> While the collapse of the pound was due immediately to large capital withdrawals, there were, of course, more fundamental causes.

<sup>2</sup> United States paper currency has been imported in large amounts into most foreign countries for purposes of hoarding.

“real” capital. Ownership can, of course, be transferred instantaneously, and this is what happens when capital is said to move very quickly. It is usually followed, however, by movements of physical wealth or services, as noted below. The confusion is thus between the transfer of physical capital and the transfer of claims to such capital.

When capital transfers are of the latter type (ownership), they involve merely acquisition by foreigners of physical or real capital already in a country. For example, Europeans might acquire title to American securities or bank deposits, which represent title to wealth in America, and give in exchange title to European wealth. America in this case has received no new wealth. America has merely exchanged ownership in its own real capital for that in European capital. On the other hand, should Europeans acquire capital here through exportation of gold to America or by sending merchandise or rendering services, the net wealth of America would thereby be increased.

In addition to the two meanings of the word capital, it can be seen that there are two ideas, often confused, regarding the movement of capital. One is as to the ownership of the physical or real capital of a country—whether foreign ownership is increased or decreased; the other is as to whether new real capital is received from abroad or is sent abroad.

When it is said that capital comes to America quickly, funds in America merely change ownership. Americans give dollars in exchange for some foreign currency or other items of value. No new real capital comes to America, however, until goods or services are received. For example, if events in Europe cause a flight of capital from Paris to New York, persons in Paris offer francs in exchange for bills on New York. The dollar is in strong demand. The dollar capital represented by the bills bought in Paris, however, is already in America. It may be owned by Americans, or it may be already owned by certain foreigners who sell to other foreigners; but the real capital is in America. It may be owned by a French exporter of goods to America, or it may come from the sale in America of securities owned by persons in France, who then sell their American dollars (claims to American real capital) for francs. It may

come from someone in a third country who sells his dollars for francs. It may represent money loaned by New York banks, in which case French banks draw bills on the New York banks and sell the bills. In any event, all that changes in the first instance is the ownership of capital already in America. Americans or foreigners have given up their title to American dollars in exchange for francs or other currencies.

This situation would probably lead to the importation of goods or gold into America. Only when gold or merchandise is shipped to this country, or services are rendered, can new real capital find its way to America. However, an increased amount of capital already in America can pass suddenly into the hands of foreign owners.

A large amount of liquid money capital, in the shape of claims to wealth or to real capital, exists in the form of bank balances, short-term evidences of debt, or securities which are readily marketable in almost any of the financial centers of the world. These transferable claims to wealth permit the quick movement of money capital (ownership) from country to country.

**Incentives to Foreign Lending.**—Under peaceful conditions and between reasonably stable and free countries investment capital is attracted or repelled according to the interest return obtainable on money, similarly as short-term funds move from one market to another. Capital tends to flow from countries in which low rates prevail to countries with high rates. In nations which are industrially advanced, profitable outlets for capital tend to decline. The supply of capital, however, may be large, as a result of accumulation and savings; consequently, prevailing interest rates are generally low in advanced countries.

In a country which is in the early stages of industrial development, on the other hand, this situation is reversed. Capital is scarce, while opportunities for the profitable utilization of funds are plentiful. For example, a railroad might be greatly needed and could earn good returns. Capital, in the sense of physical goods (tools and equipment), is very productive in such undeveloped countries. Modern farm equipment might pay for itself

several times over in grain produced, so that a farmer could afford, if necessary, to pay high interest rates on money borrowed to buy a tractor. Furthermore, as his purchasing power increased, he could buy more foreign goods, as well as more domestic goods.

These influences serve to make interest rates high in undeveloped, backward, and capital-poor countries. The surpluses of capital in highly industrialized nations, receiving only low returns when invested locally, naturally turn to undeveloped areas where returns are greater, provided political and other conditions do not frighten capital away.

A portion of the high returns in out-of-the-way parts of the world is attributable to the risk involved. It is a reward for risk and is not interest in the economic sense. In parts of Latin America and the Orient, banks frequently charge borrowers from 10% to 20%, or even more. This is because of the relative scarcity of capital, due in part to the risk and in part to the small local accumulations of loanable capital. Most lenders in advanced countries do not wish to risk their principal by lending in these less known countries unless rates are very attractive.

Foreign investment may be avoided because of a country's poor record for financial integrity, a record perhaps revealing numerous defaults and a generally careless attitude toward the payment of debts. Exports of capital to certain countries may be discouraged by high taxes, legal and other restrictions imposed by governments, as well as by the degree of economic and political freedom which exists.

Capital movements or foreign lending that take place because of fear and disturbed conditions have already been mentioned.

The return on capital and safety of the principal are not the sole considerations governing the direction of foreign investment. Foreign loans have been extended for political reasons, sometimes as a means of gaining special privileges in weaker areas abroad. Such lending has been by governments, or by banks with close governmental connections. In greater or less degree, actions of this kind have characterized the lending

careers of nearly all the great industrial nations. Defaults on foreign loans have provided the lending nation with an excuse for political control or military occupation. Foreign lending has led to unscrupulous exploitation of weaker peoples, and to competition and rivalries among world powers. At the present time the collection of debts by force has been banned by the leading nations. Foreign loans that are made for political reasons are not always for exploitation, aggression, or ulterior motives, as was usually the case historically. The United States Government has in recent years made many foreign loans to develop resources and promote the good neighbor policy, as well as to help defeat the Axis.

### **Borrowing and Lending Periods in Nations' Development.**

—Nations frequently pass through a number of more or less clearly defined stages during their industrial evolution. In the early years of this process, a country ordinarily borrows heavily from abroad. It, therefore, usually has an unfavorable balance of trade because the imported capital is represented by increased imports of merchandise.<sup>3</sup> This period is generally referred to as the borrowing stage. It leads into what is sometimes called the second or interest-paying stage. When continued borrowing takes place, the volume of interest payments due abroad equals and eventually exceeds the volume of new capital currently imported. The excess of interest payments over new borrowings generally results in a favorable balance of trade because of the increased volume of goods and services which must be exported to transfer the interest.

With the aid of the borrowed capital, the country produces a larger volume of goods and is able, therefore, to save and supply a considerable amount of its own capital. The greater supply of capital tends to lower the country's interest rates and thereby to check imports of capital. When repayments of previous borrowings exceed the volume of new borrowings, the country is said to have reached the third or repayment stage. This period is marked not only by the repayment of maturing

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<sup>3</sup> Changes in the so-called invisible trade might, of course, prevent an actual excess of merchandise imports.

loans but by repurchase of domestic securities held by foreigners. These operations tend to cause capital exports to continue to exceed capital imports, and to increase the favorable balance of trade.<sup>4</sup>

Lower domestic interest rates and increased supplies of capital encourage investment in other less developed regions. Eventually there comes a time when investments abroad exceed outstanding indebtedness abroad. The country has ceased to be a debtor nation and has become a creditor nation on net account. Thus it enters the fourth, or investing stage. The outflow of capital continues greater than the inflow, so that a favorable balance of trade is characteristic. Such a condition cannot last indefinitely, however, since interest payments from abroad gradually become larger than the current volume of foreign loans. This increase of capital imports (interest received) over capital exports tends to be reflected in an unfavorable balance of trade, the country having reached the interest-receiving stage. This is the condition attained by most of the advanced industrial nations, and may continue for an indefinite period of time. A war or other emergencies, however, may cause a country to part with much of its foreign capital in exchange for necessary materials.

It should not be thought that a nation must pass through all the stages as above described before attaining economic maturity. A nation's development does not necessarily follow precisely the above pattern. In the case of Great Britain the first three periods were passed over because of its early start as an industrial nation.

Great Britain is now a leading creditor nation with investments all over the world, although the war has greatly depleted these investments. Great Britain regularly receives large payments of interest, which fact contributes to the condition of an excess of merchandise imports, a so-called unfavorable balance of trade. The Latin American countries are mostly in the

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<sup>4</sup> These three stages were discussed by John Elliot Cairnes (1832-1875). He distinguished (1) a borrowing period, (2) an intermediate period when interest payments offset new capital imports, and (3) a period in which interest payments plus capital repayments exceed new loans, resulting in a favorable balance. Cf. Chapter 16.



borrowing stage or in the interest-paying stage. It is not only the new countries that are in these early stages; China has received much foreign capital and will probably receive considerably more as the industrialization of this vast area proceeds. The United States has passed through most of the above stages and is now a large creditor, although during the past few years foreigners have sent much capital to America for safety and investment.

**Types of Foreign Loans and Investments.**—Foreign loans and investments are sometimes classified according to the type of lender, the type of borrower, the form of the investment (whether direct or indirect), the purpose of the loan or investment, or the currency in which the loan is financed.

Loans and investments may be *public* or *private*; that is, made by governments or by private individuals and groups. When the borrower happens to be a government the loan is called a public loan. Foreign loans made by governments are usually made only to other governments. The huge loans made during the first World War by the United States Government to the Allied Powers were of this type, as have been the recent lease-lend operations and loans made by the Export-Import Bank. While governments seldom lend to foreign private interests, they commonly borrow abroad from private sources. The term public loans refers particularly to loans of this type, in which the government is the borrower. The great bulk of foreign lending and investing, however, has been by private individuals and corporations, and to private borrowers, although the United States Government has become an increasingly large foreign investor in recent years.

Foreign investment is also classified as direct or indirect. *Direct investment* takes place when a country acquires an ownership interest in property or in an enterprise in another country. Branch factories and distributing centers are of this type. *Indirect investment* involves merely the purchase of the bonds or other obligations of enterprises or other borrowers in a foreign country. The foreign obligations may be of industries, governments, provinces, cities, or individuals. The public in the

United States has invested a large amount of money in the obligations of foreign governments, as has the United States Government.

In lending money abroad the foreign obligations purchased may be in the currency of the foreign borrower or in that of the lender. Securities issued in terms of the borrower's currency are called *internal*; whereas those issued in terms of the lender's or some other currency are called *external*. Governments thus have internal debts, payable in their own currencies, and external debts, payable in some foreign currency. The United States has no external debt, although many of its obligations are owned abroad. Almost all the foreign issues sold in the United States are external, i.e., payable in American dollars. American investors would not buy any great amount of foreign bonds unless expressed in terms of American currency.

In the case of external debts, the borrower assumes the risk of exchange, since he must acquire the necessary foreign exchange in order to service the debt. Because of currency disorders and exchange fluctuations this has often become very burdensome, and has been partly responsible for failure to meet debt payments. British dollar bonds fell sharply in value when England suspended gold payments late in 1931, and the pound depreciated, notwithstanding the fact that interest and principal were payable in gold dollars. Some foreign bonds have provided for payment of interest and principal in any one of two or more currencies, according to the desire of the investor. During the currency disorders of the depression this right did not always prove of much benefit. When the United States changed the content of the gold dollar, disputes arose over the status of foreign bonds payable in American gold dollars of the former weight. Most countries paid in new type dollars, but France continued to pay American owners of French dollar bonds in the gold equivalent of the former dollars. The bonds, of course, went to a substantial premium.

The purpose of a foreign loan has a bearing on the probabilities of repayment. Capital used for a project which serves a vital social need and which in time pays for itself is obviously likely to be safer than capital used for an uneconomic or

destructive purpose. The war debts proved to be difficult to collect partly because they financed the destruction of wealth on a colossal scale. They produced no revenue to help liquidate them. Furthermore, a loan which expands exports facilitates transference of interest into the foreign currency, although this in itself may be a small factor in the transfer problem.

**Machinery for Issuing Foreign Securities.**—The centers in which long-term foreign obligations are bought and sold in large quantities are often referred to as international capital markets.<sup>5</sup> The capital markets, in contrast to the international money markets, are organized on a relatively simple pattern.

External foreign securities are generally floated in the lending country by investment banking houses or by syndicates of investment bankers. On the Continent the commercial banks occasionally float foreign issues. In the United States the law now requires that the flotation of foreign securities be only by institutions which are not affiliated with member banks of the Federal Reserve System and which are not engaged in commercial banking. The large investment banking houses, usually after extended negotiation and investigation, agree with the foreign borrower as to the terms of the new issue and the net price to the borrower. The banking house agrees to buy the entire issue at a price slightly below that at which the obligations will be offered to the public. Unless the loan is small, the banking house will be joined by several other houses in the form of a syndicate, since no one house would care to assume the entire risk of loss in the event that the issue proved difficult to sell. Security dealers and brokers throughout the country then act as middlemen in selling the issues to the ultimate investors. Sometimes foreign issues are listed on exchanges; otherwise they are bought and sold on an "over-the-counter" basis.

Because of the reckless issue of foreign securities in America during the 1920's, and the subsequent losses, the American public has not been kindly disposed toward foreign obligations. For this reason, as well as because of depressed conditions,

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<sup>5</sup> For a more detailed treatment of international capital markets, see John T. Madden and Marcus Nadler, *The International Money Markets*, New York, Prentice-Hall, Inc., 1935, Ch. III.

currency instability, transfer restrictions, and political uncertainties, very few foreign issues have been brought out in America during recent years. Also, foreigners, weighted down with debt, have not been anxious to borrow.

In long-term lending, the lenders, i.e., investors, usually include a large number of individuals, often of moderate means. In short-term lending, on the other hand, the investors are usually large financial institutions or corporations. During the twenties high-pressure salesmanship in the disposal of long-term foreign issues led to the purchase of these obligations by persons who knew little of investment principles and of the pitfalls involved. The depression losses, as the bonds declined in value, fell more heavily on these individuals than on the investment bankers, who had received their commissions upon selling the bonds. As a result, the international banking houses were the target of severe criticism and were subjected to governmental investigation. Abuses were aired, such as the floating of bonds when the lack of borrowing capacity was apparent to any competent observer, and the issuing of misleading prospectuses.

The flotation of foreign securities was a highly profitable business,<sup>6</sup> and prior to 1929 many firms in the United States which were inexperienced in the field of international finance were attracted to it. The wholesale collapse of these institutions during the depression limited the flotation of foreign obligations to a small number of investment houses.

The reforms effected by the security legislation of 1933 and 1934 apply to foreign as well as domestic issues. In the case of obligations issued by foreign governments, it is required that detailed information be filed with the Securities and Exchange Commission including full statements concerning such things as the purpose of the issue, existing public indebtedness, governmental receipts and expenditures, and any defaults that may have occurred within 20 years. A prospectus containing such information must be given to buyers of these securities. Similar provisions apply to foreign industrial issues.

<sup>6</sup> The net profit from underwriting foreign securities has been generally more than that obtained from domestic issues. Profit margins as high as 13% on certain foreign issues floated in the United States were revealed in testimony before the Senate Finance Committee in 1932.

Despite the difficulties and abuses revealed by the depression, foreign lending has an important function, as discussed in other chapters. Without it, the economic development of many countries would have been retarded. The rapid advancement of the United States was due in no small measure to investments made in this country by foreign nations, particularly Great Britain. Many parts of the world are in great need of capital to develop resources and improve their economies. The machinery for foreign investment, however, has broken down or is inadequate. This is one of the problems for post-war reconstruction.

**Effects of Foreign Investment on Trade.**—The foreign trade of a country usually tends to increase as foreign investments increase. Foreign trade also tends to follow in the direction of foreign investment.

Investment and trade go together when a firm in one country, desiring manufactured goods from another country, makes payment in its notes or other obligations. Thus a street transportation system in South America might offer its notes or bonds to an American manufacturer. The manufacturer might either sell them or hold them to maturity. Financing of this type was not uncommon prior to 1914, and was extensively employed during the first World War in trade between the United States and the Allied Powers. Usually, however, the foreign investor is distinct from the exporter.

In the case of direct foreign investments—for instance, a factory in China which is owned and managed by Americans—it is likely that in importing equipment and other necessities the managers will buy American products with which they are familiar. However, if British or other foreign equipment is clearly better and cheaper than American, the probabilities are that British equipment would be bought.

In addition to these considerations, the trade of the lending nation will be stimulated by foreign loans—largely in the direction of the borrowing country—for reasons which are more fundamental. The export of capital means the export of goods and services, as already explained. Thus, when foreign loans are made exports tend to be stimulated, and while they can go

to any part of the world in transferring the capital, they frequently tend to go to the borrowing country. As the lending country has greater exports, so the borrowing country has greater imports. A large part of America's heavy export trade during the twenties was financed, or made possible, by the extensive foreign loans made by this country. This situation was a factor in the boom of that period.

The flotation, for example, of a Brazilian government bond issue in the United States puts Brazil in the possession of American dollars in New York, dollars provided by American purchasers of the bonds. Brazil may spend some of the dollars in buying American goods, or use others in buying pounds and francs so as to purchase British and French goods. Perhaps Brazil wants most of the money in the form of her own currency to be spent for construction within Brazil. Dollars are thus offered for sale and Brazilian milreis bought. Brazilian purchasers of dollars may find them a little cheaper because of this new supply. These dollars did not exist for Brazilians previously, and can be spent only in the United States. It makes little difference, of course, whether the Brazilian Government itself spends the borrowed dollars in America, since a buyer for the dollars will eventually appear. The transaction may not be so simple as in the above illustration, but in every case of foreign lending (unless the loan is in gold) a supply of funds is set aside in the lending country which can be spent only in that country, so that the export trade of such a country is stimulated, unless, of course, the money is held or invested there.

The borrowed dollars can be used for refunding purposes, that is, refinancing a maturing loan, and have little effect on foreign trade, or they may be used to provide a supply of dollars with which to prevent exchange rates from depreciating because the borrowing country's exports were inadequate to create a large enough supply of foreign currency. If total export items are inadequate the economic remedy is to increase exports or to reduce imports, but a foreign loan may defer this necessary adjustment; it may, of course, help to meet an emergency situation of a temporary character.

Exchange rates, when free to move, facilitate the transfer of capital. Foreign loans create a supply of foreign exchange of the lending nation, for the borrowing nation, without necessarily creating an immediate and corresponding demand. This tends to lower exchange rates on the lending nation, and thereby to increase the amount of its currency bought by foreigners. Thus the newly created exchange is absorbed and exports stimulated as the exchange is utilized.

Foreign trade statistics of leading nations show that foreign loans and investments tend to correspond, in volume and direction, closely with merchandise exports.

#### **Provisions That Loans Be Spent in the Lending Country.**

—Sometimes loans have carried provisions that the proceeds are to be spent in the country making the loan. The lending syndicate may stipulate that the proceeds are to be used for purchases from companies with which it has affiliations. A clause in an underwriting contract containing instructions of this kind is known as a "tying clause."

Such clauses are often based upon a lack of understanding of the theory of international trade. The money, of course, cannot be spent anywhere but in the lending country, so that such provisions are not necessary. If dollars are loaned to Chile the dollars can be spent only in America, since they are not current elsewhere. If the borrower wants to buy steel rails and finds that he can buy more advantageously in Great Britain, he can sell his dollars for sterling and with the pounds sterling buy rails in Great Britain. Someone in Great Britain, whoever bought the dollars, would then buy American goods. In actual practice the dollars would probably come into the possession of the bank which sold Chile the sterling, and would then be sold by this bank to the nationals of any country that wanted dollars. Whoever spends them, however, must spend them in America.

#### **A Nation's Capacity to Borrow; the Transfer Problem.—**

Just as an individual may borrow more money than he is able to repay, so may a nation overborrow. A government's economic capacity to borrow abroad and to repay such loans rests fundamentally upon two things: first, its ability to raise money

internally by taxes, or in other ways, for interest and principal payments; and, second, the ability of the nation's foreign trade to expand, or other adjustments to take place, so as to effect the conversion of this money into foreign currency. Either exports of goods or services must expand so as to increase the supply of foreign exchange to be turned over to the foreign creditors, or imports must be curtailed so as to leave a surplus of bills.

Whether a country is able to raise money internally to make the required foreign payments depends upon such things as the wealth and prosperity of its people, the degree to which they are already taxed, their sense of integrity, and the type of government. These matters, it will be seen, cannot be measured with any great degree of precision. Perhaps the most important is a public sense of integrity and desire to meet legitimate obligations.

Under reasonably stable and peaceful conditions the problem of transferring capital to another country is not likely to be serious, provided artificial restrictions such as tariffs and other regulations do not interfere with exports, and provided that the amounts are not excessively large. If a nation has the money available internally, foreign buyers ordinarily appear for this currency, i.e., for the nation's goods, so that the money can be converted into the proper foreign exchange. A nation, however, might see its currency depreciate in the foreign-exchange market, in order to stimulate enough foreign buyers of its goods or services. Such depreciation, which means increased cost of foreign money and goods, may be objectionable. Thus, during the thirties most countries instituted exchange control to prevent depreciation. Regardless of the merits of such control, it made the transfer of funds much more difficult. Economic forces, if allowed reasonable freedom, will tend to expand a country's export trade so as to facilitate the transfer of capital, and perhaps curtail the import trade, thereby helping to bring a balance between the demand and supply of foreign bills.

The transfer problem was discussed actively in connection with German reparations. Many persons felt that the amounts Germany was called upon to pay were in excess of what could



be transferred without interfering with exchange rate stability. This question is discussed below.

In periods of economic distress, or when very large sums are to be transferred quickly, a serious transfer problem may arise. When a nation is unable to sell enough of its goods and services to other nations, it has no way of creating a supply of foreign exchange except through the shipment of gold, or through foreign borrowing. If the country has little gold or foreign balances to draw upon, the transfer problem may become acute. Even if the country does have gold to export, assuming the gold standard and a foreign market for gold, the currency and credit system may be damaged by sizable gold exports. Many nations during the world depression were faced with this situation. Unable to dispose of the accustomed amount of goods and services abroad because of rising tariffs and exchange restrictions imposed by other nations, or because of depressed markets, and with small gold stores or foreign deposit balances, such countries defaulted on their foreign obligations.

When large capital movements take place suddenly, therefore, the nation called upon to provide for the outflow of funds may not have foreign balances (or gold) to spare, and cannot expand its exports or services in such short space of time. The result will be a breakdown of exchange rates or, under exchange control, restrictions on the sale of exchange so that the funds are not transferred. This has become a difficult problem in view of the large amounts of capital which tend to move from country to country quickly. It reveals the inherent difficulties that come from having a variety of currency units and systems in the world, and the irregular demands for one currency as opposed to another. It is well-nigh impossible to devise a satisfactory clearing system under such conditions. The solution is, of course, an international currency system, which is also difficult for other reasons.

Nations borrowing abroad may make the mistake of employing funds borrowed for short periods, for purposes which should be financed with long-term capital. Short-term funds have been used for projects which can produce revenue to repay the capital only over a long period of time. If creditors refuse to

renew such short-term advances, or call in the funds, difficulties may be experienced. During the depression, Germany suffered because of unwise use of its short-term credits.

Centers such as New York and London, which are repositories for large amounts of foreign money which assumes the form of bank balances or liquid securities that can be quickly converted into cash, are in a vulnerable position if they do not keep themselves ready to remit promptly should foreign nations withdraw funds hastily. Unless such centers can maintain a relatively free market and avoid the rigid restrictions of exchange control, their usefulness as financial centers is impaired.

**Governments and Foreign Investment.**—Foreign relations of a nation are vitally affected by the investments and trading activities of its citizens abroad, and also by foreign money invested in it. Foreign investments have been used as a means of political expansion. The conquest of India by Great Britain was intimately interwoven with the activities of the English East India Company. Similarly, other European powers obtained foreign possessions through the instrumentality of their traders, trading companies, foreign investments, and concessions.

Usually, either directly or indirectly, foreign loans have political consequences and ramifications. They may lead to complications and even war, particularly in disturbed parts of the world or where international rivalries are keen. After the first World War it was reported that Germany was encouraging Americans to invest in Germany, so that the American public would become sympathetic with Germany's position.

Many of the loans that were extended to China earlier in this century were made to serve political as well as economic ends. The negotiations were thus participated in by foreign diplomats, each seeking to secure special privileges, or to forestall the ambitions of other nations. Railroad and other valuable concessions were thus granted; provisions were accepted by China regarding the appointment of foreign advisers who were to be citizens of this country or that country; or fiscal administration was to be in the hands of foreigners to provide security for the loan.

Loans to Latin American and other countries have frequently contained provisions that customs revenues were to be pledged for the service of the loan, and that a foreign collector of the customs was to be appointed, either at the time the loan was made, or in case of default. Such administration of domestic governmental finance by foreigners is usually offensive to the borrowing nation, and has been the source of trouble.

Governments themselves ordinarily do not engage in foreign investment, and when they do so it is usually for political reasons. Thus the British Government owns about 40% of the Suez Canal Corporation, while the government of France has invested extensively in its "spheres of interest" abroad. During the first World War, governments helped each other by means of loans. These were not investments, but were purely for political reasons. During and prior to the second World War, the United States Government made extensive foreign loans, particularly in connection with the good neighbor policy.

Great differences in governments' policies are apparent in regard to the making of foreign investments by their citizens. In France, prior to the war, each foreign issue had to secure governmental approval before it could be publicly floated in France. England, on the other hand, placed no restrictions on foreign investment. The policy of the United States has been in some respects a compromise between French and British practice. This is discussed in Chapter 33.

## CHAPTER 23

### FOREIGN INVESTMENTS OF THE UNITED STATES

**History of United States Foreign Investments.**—After the Revolutionary War and the establishment of independence, the United States was economically exhausted and its financial condition precarious. The continental currency, printed to finance the war, had depreciated to the point where it was all but worthless, and the country was saddled with debts which at that time seemed very large. The new country's credit in foreign capital markets was so low that requests for loans from the political enemies of Great Britain met with polite refusals.<sup>1</sup>

This condition of low credit standing in the eyes of foreign lenders, however, did not last many years. The Industrial Revolution, involving substitution of machines for hand labor and of factories for home production, was under way in England and was expanding production rapidly, permitting increased savings and the accumulation of wealth. It was not long before the new capitalist classes in England and Europe, seeking greater returns for their surplus funds, turned their attention to America. Capital came to the United States, and by 1850 foreign investments in this country amounted to about \$250,000,000.<sup>2</sup> After the Civil War, the great industrial development which took place, was financed largely with capital from Great Britain, the Netherlands, and Germany. In 1910 foreign capital in the United States was estimated to have amounted to about \$6,500,000,000, more than half of which was from Great Britain.<sup>3</sup>

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<sup>1</sup> A loan of \$195,000 was made by France during the war.

<sup>2</sup> *Foreign Investments in the United States*, U. S. Bureau of Foreign and Domestic Commerce, 1937, p. 22.

<sup>3</sup> *Ibid.*, p. 23.

Prior to 1874, the United States had an unfavorable balance of trade, which largely represented new capital coming to this country. The United States was in the borrowing stage previously referred to. From this date, however, until the present time, the balance of trade has, with two exceptions, been regularly favorable, representing interest and principal payments by this country and later new capital exports from this country.

During most of the country's history the United States was the recipient of foreign capital, rather than the source of capital for other countries. It was about 1900 that American capital began to flow out of this country in sizable amounts into foreign countries. The capital went principally into the neighboring countries of Canada, Mexico, and Cuba in agricultural and industrial enterprises. In 1914, American investments abroad totaled about two and one-third billion dollars. However, investments in the United States by foreigners amounted to about six billion dollars, so that this country was a net debtor to the extent of something over three and one-half billion dollars.<sup>4</sup>

The war, however, changed this situation. America loaned large sums to Europe before it entered the war, during the war, and after the war, so that it became a great creditor nation. In the first place, upon the outbreak of the war in 1914, large amounts of American securities owned by foreigners were sold in this country in order to secure American dollars to aid in financing the war. This resale to Americans during the course of the conflict amounted in all to about two billion dollars. In the second place, the interruption of industry in Europe brought about a tremendous stimulation of American exports, the financing of which was accomplished at first largely by private loans to Europe and, later, after America's entry into the war, by much larger United States Government loans to the various allied nations.

When hostilities had ceased, the United States, instead of being a debtor to other countries, was a net creditor to the extent of over ten billion dollars. Three-fourths of the debt to the United States, however, represented obligations of the allied

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<sup>4</sup> *Op. cit.* A discussion of the different estimates of foreign capital in America appears on p. 24 of the above study.

countries to the Government of the United States, which have been only partially repaid, and which may now be written off as uncollectible. The war suddenly thrust the United States to the fore in international economic and financial affairs. The American dollar was everywhere regarded as a safe and reliable currency, partly because of the inflation and disturbed conditions in Europe, but also because of the wealth and political stability in the United States. The dollar was well known in the cities of Europe, in Shanghai, or in Buenos Aires. American money, usually paper, would be found in the tills of hotels, banks, and large stores. The dollar was also a familiar unit for business and financial transactions.

**United States Foreign Investments.**—The British public long ago became familiar with the foreign market as an outlet for funds. The American public learned of it during and after the first World War, and, in typical American fashion, went to the extreme in a scramble to lend money to foreigners. During the twenties, particularly 1925–1930, investment houses, anxious for the commissions on floating loans, vied with each other to find foreign borrowers—governments, cities, or private businesses. Highly paid agents with fat expense accounts were sent abroad, especially to Latin American countries, to fawn on officials there and persuade them that they could use American money. Friends and relatives of these foreign officials—anyone who might influence the negotiations—were lavishly entertained. The officials were not reluctant to see money coming into the treasury; some purpose for the money could usually be discovered. Billions of American dollars were poured into securities issued by national, provincial, and local governments and private corporations in Europe, Latin America, Australia, Canada, and in the Far East.

The bonds of these foreign governments or corporations were sold to the unwary American public. Often on the advice of banks and investment houses, persons who should have invested only in the most conservative securities put their savings into these precarious issues, which in some cases yielded 8% or more in interest. The high rate of interest alone should have

been a warning. At its peak the foreign bond portfolio of the United States amounted to slightly over \$11,000,000,000.

When the borrowing countries began defaulting in their interest payments during the nineteen thirties, and when the securities declined in value, sometimes to only a few cents on the dollar, the losses to American investors were heavy. As depression slowly gave way to recovery, most of these foreign securities improved somewhat in value. Readjustments were made in many cases, but a large portion of the money will have to be permanently written off.

As a result of the reduction in value of these investments, America's position as a creditor nation was weakened. Furthermore, the large amount of foreign capital that came to America for investment and safety, as a result of the depression and the upset political conditions in Europe, also reduced the creditor status of this country, as noted below.

From the international standpoint, these bad investments did not increase good feeling. The countries to the south blamed the United States for lending so much and, at the same time, for wanting to collect what it had lent. American creditors in turn felt that the Latin American countries were not making proper efforts to pay. The war debts and their non-payment were also the source of a great amount of dispute and ill-will between Europe and the United States. Similarly, the German post-war bonds sold in the United States were the subject of controversy and ill-feeling.

Table 11 shows the status of foreign dollar bonds, issued in America, which went into default. Largely as a result of readjustments, sinking fund and redemption operations, and net repurchase by the borrowers, the total sum in partial or complete default declined from \$2,028,000,000 at the end of 1936 to \$983,000,000 at the end of 1940, par values. The United States at the latter date also held about \$2,000,000,000 of foreign bonds that had never been in default.

Although America has lost heavily from bad loans, the foreign investments of this country are still extensive. American oil and mining companies have large interests in Mexico, Venezuela, Colombia, Bolivia, Chile, and Peru. American automo-

bile and other industries have established branch factories in Canada, Europe, and other parts of the world. Coffee, sugar, and rubber plantations in various countries are owned by Americans. As can be seen in Table 12, direct investments of this type amounted at the end of 1940 to \$7,000,000,000 while indirect, or so-called portfolio, investments amounted to \$3,591,000,000, a total, including short-term assets, of \$10,975,000,000 of foreign investments. The portfolio investments are in the form of foreign securities, the market value of which, as can be seen from Table 13, is less than the above figure, which is the face value. In addition, American bank balances abroad and other short-term foreign assets amounted to \$384,000,000. The largest amount of American money abroad is in Latin America. Then comes Canada and Newfoundland, followed by Europe. The money invested in foreign countries has come from the pockets of people all over the United States. It is not Wall Street that provides the money, but the American public. Any person who buys bonds—British bonds, French bonds, or foreign securities of any type—is putting his money to work abroad.

As a deduction from these figures, in order to determine how America stands as a net creditor, are \$5,717,000,000 of American securities and other long-term investments owned by foreigners at the end of 1940, as shown in Table 14. In addition to this, foreign-owned, short-term assets in the United States amounted to \$3,978,000,000, a large amount of this being refugee capital, making a total at the end of 1940 of \$9,695,000,000. The net creditor position of the United States was, therefore, only about \$1,280,000,000, which was materially less than what it had been.<sup>5</sup> The value of the governmental debts from the first World War is not considered in arriving at the net creditor position of America.

**Direct Investments: American Factories Abroad.**—From Table 12 it can be seen that Americans own and operate a large number of properties in foreign countries. The inter-war period

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<sup>5</sup> The estimates are based on par values and book values, so that this figure is only an approximation.



saw the establishment abroad of an increasing number of American factories or assembly plants. Several influences were responsible for this tendency. One was the rising trade barriers. Tariffs and other restrictions against American manufactures were raised so high that they seriously reduced the market and in some cases cut it off completely. Foreign branch factories were therefore established to overcome this obstacle. Partial avoidance of tariffs was obtained by American-owned assembly plants which assemble the article on foreign soil from parts imported from the United States. This procedure often proved more practical than complete production abroad. A factory or assembly plant in a foreign country is able to take advantage of more favorable tariff treatment from other nations on its exports than it would receive on exports from the United States. Thus American factories located in England or Canada secured imperial-preference rates on merchandise shipped to other parts of the British Empire.

Another factor causing American industries to establish factories abroad is the economy of locating near to the foreign market or to raw materials. Freight charges are greatly reduced by locating factories close to markets and materials. Furthermore, foreign good-will is usually obtained for an article when it is produced within the country. Labor costs are commonly less abroad than in the United States, so that producing in a foreign country enables American capital to take advantage of low foreign wages.

Although tariffs and other restrictions may be avoided, and certain savings introduced by producing abroad, other difficulties result, such as the risks of currency and exchange conversion and the dangers from political disturbances. American industries lost heavily, first in the troubles in Spain and China, and as the war spread, in most of the other parts of the world. These difficulties have been an important deterrent to the extension of American industries abroad.

**American Capital Movements Since 1930.**—During the first years of the depression, following the stock market collapse in 1929, the flow of capital continued to be from America to

TABLE II. INTEREST-DEFAULT STATUS OF FOREIGN DOLLAR BONDS, BY COUNTRIES, DECEMBER 31, 1940 \*  
(In millions of dollars)

Country and Area	Issues Not in Default		Issues in Default		Percentage of Defaults of Total Investments
	Original Terms Unchanged	Terms Adjusted	Partial	Complete	
<b>Canada and Newfoundland:</b>					
Canada .....	\$1,321.8	\$ 28.4	\$ 35.4	\$ 0.7	2.6
Newfoundland .....	3.6	.....	.....	.....	.....
Total .....	1,325.4	28.4	35.4	.7	2.6
<b>West Indies:</b>					
Cuba .....	10.3	40.8	.....	9.8	16.1
Dominican Republic .....	7.2	.....	.....	.....	.....
Haiti .....	5.6	.....	.....	.....	.....
Total .....	23.1	40.8	.....	9.8	13.3
<b>Central America:</b>					
Costa Rica .....	.....	.....	7.3	.7	100.0
Guatemala .....	.....	1.1	1.3	.3	59.3
Panama .....	3.2	.1	.....	7.8	70.3
El Salvador .....	.....	.....	.....	4.1	100.0
Total .....	3.2	1.2	8.6	12.9	83.0
<b>South America:</b>					
Argentina .....	133.3	51.6	.....	5.6	2.9
Bolivia .....	.....	.....	.....	53.6	100.0
Brazil .....	10.5	.....	.....	244.8	95.9
Chile .....	24.0	21.3	.....	138.2	75.3
Colombia .....	12.4	1.3	23.5	84.8	88.8
Peru .....	.....	.....	.....	54.0	100.0
Uruguay .....	.1	31.9	.....	2.6	7.5
Total .....	180.3	106.1	23.5	583.6	67.9
<b>Europe:</b>					
Belgium .....	11.5	.....	.....	3.0	20.5
Bulgaria .....	.....	.....	2.0	2.8	100.0
Czechoslovakia .....	.....	.....	.....	1.9	100.0
Danzig .....	.....	.....	.....	1.8	100.0
Denmark .....	80.9	.....	.....	.....	.....
Estonia .....	1.3	.....	.....	.....	.....
Finland .....	4.8	1.5	.....	.....	.....
France .....	8.4	.....	.....	.....	.....
Germany and Austria .....	1.9	4.2	22.7	74.4	94.0
Greece .....	.....	.....	14.2	.6	100.0
Hungary .....	.....	5.8	19.2	6.9	81.8
Ireland .....	.4	.....	.....	.....	.....
Italy .....	.3	.....	.....	73.4	99.6
Lithuania .....	.4	.....	.....	.....	.....
Norway .....	61.5	.....	.....	.....	.....
Poland .....	.....	.....	.....	45.4	100.0
Rumania .....	.....	.....	.....	4.4	100.0
Turkey .....	10.7	.....	.....	.....	.....
U. S. S. R. ....	9.8	.....	.....	.....	.....
Yugoslavia .....	5.6	.....	.....	23.8	81.0
Total .....	197.5	11.5	58.1	238.4	58.7
<b>Asia:</b>					
China .....	1.1	.....	.....	12.3	91.8
Japan .....	105.5	.....	.....	.....	.....
Philippine Islands .....	35.1	1.5	.....	.....	.....
Total .....	141.7	1.5	.....	12.3	7.9
<b>Oceania and Africa .....</b>	95.0	1.8	.....	.....	.....
<b>Grand Total .....</b>	<b>\$1,966.2</b>	<b>\$191.3</b>	<b>\$125.6</b>	<b>\$857.7</b>	<b>31.3</b>

\* See footnote on opposite page.

(Source: *Foreign Commerce Weekly*, July 19, 1941)

Europe. America had been loaning large sums to Europe; during the depression, however, the continuation of the outflow of capital did not represent new loans by Americans, since foreign investing almost completely dried up, but represented principally withdrawals by foreigners of funds invested or deposited in this country. Because of fears regarding currency depreciation, foreign banking funds carried in this country declined sharply.

In 1934, the movement of funds turned toward America from Europe. From then until about the end of 1940, the net flow of capital was strongly in the direction of the United States, with the result that the creditor position of this country declined considerably. In 1935, the inflow consisted chiefly of short-term funds, as foreign banks and industries built up their balances in America. In 1936, although the total inflow of capital was less than in the preceding year, new long-term investments in America by foreigners were greater than in 1935. In 1936, \$792,000,000 of American stocks and bonds were sold to foreigners. Foreign funds in the United States amounted in January, 1937, to over seven and one-half billion dollars, of which over six billions consisted of long-term investments and about one and one-half billions of short-term balances.

As the war came nearer, the inflow of funds was accelerated and in 1939 foreign banking funds in this country increased by \$1,006,000,000. Prior to and during the war, American banking funds abroad declined. After the collapse of France the inflow of capital into the United States was especially large, and by the end of 1940 short-term assets here amounted to \$3,978,000,000 and total assets to \$9,695,000,000. This marked a peak; by the spring of 1942 over half a billion dollars had flowed out. Beginning in April, 1940, much of this foreign capital was frozen by action of the United States Government, the reason being to protect it for owners in countries overrun by Germany, and also to prevent its use for Axis purposes.

*(Footnote for Table 11, opposite)*

\*By interest default is meant the failure of the borrower to pay interest in conformity with the provisions of the bond indenture—the gold clause excepted. Negotiations often result in the lowering of the contract rate of interest, the cancellation of past-due coupons, the issuance of income bonds in exchange for the original bonds, or some other solution thought of as permanent. When such revisions are accepted by the bondholders and adhered to by the debtors, the contracts are considered as having been amended, and the issues are treated as no longer in default. For the purposes of the above table, interest-default was based on the status of the last coupon payable in 1940. Certain Mexican, Russian, and Chinese issues long in complete default as to both principal and interest are excluded from these estimates.

A number of reasons accounted for the importation of foreign capital during the thirties. First was the political and economic instability abroad. Fears of currency depreciation, high taxes, and governmental restrictions caused capital to seek safety in America where money was regarded as more secure. The ominous political developments and the approach of war tended to stimulate the flow of capital toward the United States. This was perhaps the major factor. Another consideration in the minds of many foreigners sending funds to the United States was the desire to share in American recovery profits. The exceptionally low prices of many foreign securities held by Americans also led to their repurchase by foreigners. The drastic cut in the gold dollar in January, 1934, and the failure of the general price level in America to rise correspondingly made American securities and foreign dollar securities attractive to foreigners.

The inflow of capital was effected to a considerable extent by the importation of gold. The gold stock of the United States, excluding earmarked gold, increased from about eight billion dollars at the end of 1934 to nearly twenty-three billion dollars in the fall of 1942. In 1939, net gold imports amounted to the huge sum of \$3,574,000,000 and in 1940 to the still larger sum of \$4,744,000,000. The United States now has by far the largest store of gold in history, and holds most of the monetary gold of the world.

Most of this foreign capital in the United States is of a liquid short-term character that might quickly be withdrawn. The capricious nature of this liquid capital and the possibility of its sudden withdrawal have caused it to be called "hot money." It includes the deposits of foreigners in American banks and the large amounts of liquid American securities owned by foreigners, which could be sold in the New York market and the proceeds withdrawn. The flow of money of this kind from country to country usually takes place with little relation to domestic needs for capital, often coming in when needed least and sometimes going out when needed most. A difficult problem is that of how to provide for capital transfers from one currency into another without upsetting economic conditions including exchange rates.

TABLE 12. UNITED STATES INVESTMENTS IN FOREIGN COUNTRIES,  
DECEMBER 31, 1940  
(In millions of dollars)

	Direct	Portfolio (par value)	Short-Term Assets	Total
Canada and Newfoundland..	\$2,103	\$1,675	\$ 36 <sup>a</sup>	\$3,814
West Indies.....	674	79		
Central America and Mexico..	546	26	123	3,897
South America.....	1,551	898		
Europe.....	1,420	636	101	2,157
Asia.....	422	160	118	700
Oceania.....	120	98		
Africa.....	131	19	6 <sup>b</sup>	407
International.....	33			
Total.....	\$7,000	\$3,591	\$384	\$10,975

<sup>a</sup> Excluding Newfoundland.

<sup>b</sup> Including Newfoundland.

(Source: For portfolio investments, U. S. Department of Commerce, *The Balance of International Payments of the United States in 1940*, p. 52; for direct investments, U. S. Department of Commerce, *American Direct Investments in Foreign Countries—1940*)

TABLE 13. MARKET VALUE OF FOREIGN DOLLAR BONDS,  
DECEMBER 31, 1940  
(Per cent of par value)

Areas	Issues in Default as to Interest	Issues not in Default	All Issues
Canada and Newfoundland.....	46.9%	88.9%	87.9%
West Indies.....	50.0	60.5	59.1
Central America.....	32.1	76.4	39.7
South America.....	13.6	56.8	27.4
Europe.....	18.0	34.2	24.8
Asia.....	6.8	63.0	58.6
Oceania and Africa.....	.....	56.0	56.0
Average market value, Dec. 31, 1940.	16.9%	75.3%	57.0%
Average market value, Dec. 31, 1939.	16.5	84.8	64.7

TABLE 14. FOREIGN INVESTMENTS IN THE UNITED STATES  
(Year-end data; in millions of dollars)

Type of Investment	1938	1939	1940
Long-term investments:			
Direct investments (book value) . . . . .	\$1,895	\$1,978	\$2,000
Common stocks (market value) . . . . .	2,715	2,493	1,947
Preferred stocks <sup>a</sup> (par value) . . . . .	530	499	450
Bonds <sup>b</sup> (par value) . . . . .	580	570	570
Miscellaneous investments (capitalized income) . . . . .	750 <sup>c</sup>	750 <sup>c</sup>	750 <sup>c</sup>
Total long-term investments . . . . .	\$6,470	\$6,290	\$5,717 <sup>d</sup>
Short-term investments . . . . .	2,231 <sup>e</sup>	3,296 <sup>e</sup>	3,978
Grand total . . . . .	\$8,701	\$9,586	\$9,695

<sup>a</sup> The market value of the preferred stocks was estimated as follows: 1938, \$372,000,000; 1939, \$352,000,000; and 1940, \$304,000,000.

<sup>b</sup> The market value of bonds was estimated as follows: 1938, \$432,000,000; 1939, \$425,000,000; and 1940, \$430,000,000.

<sup>c</sup> Includes estimated holdings of \$100,000,000 of United States national, state, and municipal government bonds.

<sup>d</sup> Exclusive of \$150,000,000 loaned and invested in the United States by the British Government during 1940 for the construction and expansion of plant facilities.

<sup>e</sup> Revised.

**War Debts.**—The so-called war debts resulted from money loaned by the United States Government direct to European governments during and after the first World War. The money was used to pay various expenses of the European nations, some of the expenses contracted before we entered the war, some during our participation in the war, and some after the Armistice. The money went especially to buy munitions, textiles, raw materials, food, and other articles. The sum originally amounted to \$10,338,000,000.<sup>b</sup>

After the close of the war the nations one by one made arrangements with the United States for the repayment of these loans. In these refunding agreements the United States reduced the interest payments to such an extent that the effect was to cut the debts nearly in half. In other words, if the principal of the debts were cut in half, and rates of interest prevailing at the time the debts were contracted applied to the remaining half, the

<sup>6</sup> Accumulations of interest prior to funding increased the funded amount to \$11,231,000,000.

countries would pay on the average approximately what they were required to pay under the funding agreements. On this basis Great Britain was supposed to pay some 70% of her debt, France about 40%, and Italy 20%.

In the period following the war, Europe endeavored to bring pressure upon the United States to cancel the debts, and to link them to the German reparations problem. The United States took the position that the debts were not excessively burdensome, that they represented business transactions, and that Europe was able to pay and should pay. The United States steadfastly refused to participate in a conference to discuss debts and reparations, knowing that such a conference would be used to present America with a united front for debt cancellation.

The nations declared that they must have reparations from Germany if they were to pay their debts to America. The United States was thus made to appear as the stumbling block to European settlement. (The original reparation bill was more than three times the war debts.) The United States, the one nation that opposed the principle of indemnities, and refused to share in them, was in this manner held up as responsible for their existence.<sup>7</sup>

As a result of the world depression, President Hoover in June, 1931, offered to postpone payments on the war debts for one year, if the European governments would similarly postpone reparation payments. This was immediately accepted, and marked the end of both war debt and reparation payments. With the exception of payments by Finland and a few small token payments by other debtors, no money has since been received by the United States.

Because of the defaults and the attitude of Europe toward these obligations, the Johnson Act was passed by Congress in 1934, prohibiting governments that are wholly or partially in default to the United States Government from borrowing in this market. Private corporations in such countries could still borrow here.

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<sup>7</sup> The United States presented to Germany a bill for the costs of the army of occupation, together with certain claims for damages.

Total sums received by the United States as war debt interest and principal payments amounted to about \$2,750,000,-000.<sup>8</sup> On March 31, 1940, the total owing amounted to \$13,345,000,000 as can be seen in Table 15.

The debts were the source of a great deal of controversy and ill-will on both sides. The United States felt that the European nations were remiss in not making more serious efforts to pay. On the other hand, Europeans were almost unanimous in believing that the debts were unjust and well nigh impossible to pay and that the United States was mercenary in urging payment.

**Lend-Lease Act.**—The Lend-Lease Act of March, 1941 was designed to avoid the troubles arising out of advances made by the United States Government during the first World War. As dollar resources of Great Britain became depleted and as sentiment in the United States turned more and more against the Axis, it was clear that action of some kind was necessary in order to aid Great Britain. The Act accordingly permits the President "to sell, transfer title to, exchange, lease, lend, or otherwise dispose of, to any such government . . ." (i.e., "any country whose defense the President deems vital to the defense of the United States")<sup>9</sup> any defense article, which is defined in broad terms.

The President was given wide authority by the Act "in the final determination of the benefits to be provided to the United States." In his Fifth Report to Congress on Lend-Lease Operations the President said:

. . . The transfers made under the Lend-Lease Act are not commercial loans to other nations. They are contributions of material to a common pool with which a common war is being waged. In return, other United Nations are contributing their utmost to the common fight—in men, materials and machines—and are furnishing us with

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<sup>8</sup> The Act of May, 1933, known as the Thomas Amendment, empowered the President, for a period of six months, to accept silver in payment of war debts—such silver to be valued at a price not to exceed 50 cents an ounce and the aggregate value not to exceed \$200,000,000. Under this provision, 22,735,000 fine ounces of silver were received on account of debts due in June, 1933, and credited at 50 cents an ounce. The market price of silver at that time was about 34 cents. Such silver payments came from Finland, which paid in full, and from Great Britain, Italy, Czechoslovakia, Rumania, and Lithuania. These latter countries made token payments only.

<sup>9</sup> Lend-Lease Act, Section 3, Public Law No. 11, 77th Congress, 1st Session.



TABLE 15. INDEBTEDNESS OF FOREIGN GOVERNMENTS TO THE UNITED STATES AS OF MARCH 31, 1940  
(Thousands of dollars)

Country	Total Debt Minus Pay- ments on Principal	Total Payments Received	FUNDED INDEBTEDNESS				UNFUNDED DEBTS <sup>a</sup>	
			Indebtedness		Payments on Account		Payments on Account <sup>b</sup>	
			Principal (Net)	Accrued Interest	Principal	Interest	Principal	Interest
Armenia.....	\$ 23,901	\$ 52,191	\$ 400,680	\$ 56,873	\$ 17,100	\$ 14,490	\$ 2,058	\$ 18,544
Belgium.....	457,553	12,287	.....	.....	.....	.....	10,000	2,287
Cuba.....	165,789	20,134	165,241	547	19,830	1,247	.....	304
Czechoslovakia.....	21,321	1,248	16,466	4,855	.....	.....	.....	1
Estonia.....	8,143	5,891	8,042	100	958	4,624	.....	309
Finland.....	4,200,333	486,076	3,863,650	336,683	161,350	38,650	64,690	221,386
France.....	26,017	863	25,980	36	863	.....	.....	.....
Germany (debt of Austria) <sup>c</sup> .....	5,574,431	2,024,849	4,368,000	1,206,431	232,000	1,232,771	202,182	357,897
Greece.....	34,526	4,040	31,516	3,010	981	1,879	3	1,159
Hungary.....	2,413	518	1,909	504	74	443	.....	59
Italy.....	2,025,526	100,830	2,004,900	20,626	37,100	5,767	364	57,599
Latvia.....	8,790	762	6,879	1,911	9	622	.....	131
Liberia.....	.....	36	.....	.....	.....	.....	26	10
Lithuania.....	7,870	1,238	6,198	1,673	235	1,002	.....	2
Nicaragua.....	169	169	.....	.....	.....	.....	142	27
Poland.....	266,815	22,646	206,057	60,758	1,287	19,311	.....	2,048
Rumania.....	64,914	4,791	63,861	1,054	2,700	29	1,799	263
Russia.....	395,002	8,750	.....	.....	.....	.....	.....	8,750
Yugoslavia.....	61,818	2,589	61,625	193	1,225	.....	728	636
Totals.....	\$13,345,161 <sup>d</sup>	\$2,749,908	\$11,231,004	\$1,095,253	\$475,711	\$1,320,851	\$281,990	\$671,354

<sup>a</sup> The principal amount of unfunded indebtedness on March 31, 1940 was \$204,561,000 (Armenia, \$11,960,000, and Russia, \$192,601,000) and accrued interest of \$214,342,000 (Armenia, \$11,941,000, and Russia, \$202,401,000).

<sup>b</sup> Payments of governments which have funded their debts were made prior to the date of the funding agreements.

<sup>c</sup> The German Government was notified that the Government of the United States looked to the German Government for the discharge of this indebtedness of the Government of Austria to the Government of the United States.

<sup>d</sup> Includes balances of amounts postponed under provisions of the joint resolution of December 23, 1931.

(Source: U. S. Department of Commerce, *Statistical Abstract of the United States*, 1940, p. 209)

the weapons and supplies which we, rather than they, can most effectively use. . . .

. . . The real costs of the war cannot be measured, nor compared, nor paid for in money. They must and are being met in blood and toil. But the financial costs of the war can and should be met in a way which will serve the needs of lasting peace and mutual economic well-being.

All the United Nations are seeking maximum conversion to war production, in the light of their special resources. If each country devotes roughly the same fraction of its national production to the war, then the financial burden of war is distributed equally among the United Nations in accordance with their ability to pay. And although the nations richest in resources are able to make larger contributions, the claim of war against each is relatively the same. Such a distribution of the financial costs of war means that no nation will grow rich from the war effort of its allies. The money costs of the war will fall according to the rule of equality in sacrifice, as in effort. . . .

The form which settlement of lend-lease aid will take after the war is not clear. Unused materials are to be returned. The agreement with the United Kingdom, which served as a model and embodies the same terms as agreements with Soviet Russia, China, and other countries, authorizes postponement of settlement until after the war and repayment in a form that would not burden commerce. Aid received by the United States from other countries is also to be considered. With American troops overseas, this aid is substantial.

Article VII in the Master Agreement with China reads :

In the final determination of the benefits to be provided to the United States of America by the Government of the Republic of China in return for aid furnished under the Act of Congress of March 11, 1941, the terms and conditions thereof shall be such as not to burden commerce between the two countries, but to promote mutually advantageous economic relations between them and the betterment of world-wide economic relations. To that end, they shall include provision for agreed action by the United States of America and the Republic of China, open to participation by all other countries of like mind, directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all peoples; to the elimination of all forms of

discriminatory treatment in international commerce; to the reduction of tariffs and other trade barriers; and, in general, to the attainment of economic objectives identical with those set forth in the Joint Declaration made on August 14, 1941, by the President of the United States of America and the Prime Minister of the United Kingdom. . . .

In the fall of 1942 lend-lease aid was being extended at the rate of about \$8,000,000,000 per year and was increasing rapidly. By September, 1942, total lend-lease aid had amounted to \$6,489,000,000. Countries eligible for lend-lease assistance, as of September, 1942, were: <sup>10</sup>

Argentina	Cuba	Haiti	Panama
Belgium	Czechoslovakia	Honduras	Paraguay
Bolivia	Dominican Republic	Iceland	Peru
Brazil	Ecuador	Iran	Poland
British Commonwealth of Nations	Egypt	Iraq	Turkey
Chile	El Salvador	Mexico	U.S.S.R.
China	France (Free)	Netherlands	Uruguay
Colombia	Greece	Nicaragua	Venezuela
Costa Rica	Guatemala	Norway	Yugoslavia

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<sup>10</sup> Sixth Report to Congress on Lend-Lease Operations.

## CHAPTER 24

### SILVER IN INTERNATIONAL FINANCE<sup>1</sup>

**Silver in Currency Systems.**<sup>2</sup>—At the present time no country has the silver standard, although many countries have silver coins in circulation. When China left silver in 1935, there came to an end a period of many centuries, during which silver had served as a monetary standard and measure of values in some part of the world. It has served practically every country at some time or other. Until the large gold discoveries of modern times silver was the principal currency of the world, and was found in the market places of all countries. Gold was too valuable for most of the ordinary transactions. Bimetallism, the joint use of gold and silver, prevailed extensively for many years, but for the 75 years preceding the currency disturbances of the thirties, gold held sway alone throughout most of the civilized world. Silver continued a long time in certain areas, but has finally disappeared as a currency standard.

Today silver is merely a commodity, in the same sense that copper, nickel, or iron are commodities. The fact that silver continues to be used as the material for coins does not mean the silver standard. The value of silver coins in all countries is now divorced from the value of the silver in the coins, so that the coins might just as well be made of brass or iron. Such coins are now token money. Free coinage of silver no longer exists anywhere, so that in no country is it possible to obtain a fixed amount of money for silver bullion. Conversely, the monetary value of silver coins is greater than the value of the silver they

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<sup>1</sup> Much of the material in this chapter is based on the author's monograph "The United States Silver Policy," *Foreign Policy Reports*, Vol. XII, No. 8, July 1, 1936.

<sup>2</sup> A discussion of exchange rates on silver-standard countries is contained in Chapter 6 on Foreign Exchange.

contain, so that a person would be foolish to melt down coins to obtain silver. Silver can be bought as bullion much more cheaply than obtained from coins. According to the present price of silver (about 45 cents an ounce, September, 1942), the American silver dollar contains about 40 cents worth of silver. Originally, when this country had bimetallism and when the price of silver was much higher in terms of gold money, the American silver dollar contained one dollar's worth of silver.

Although silver coins are at present merely token money, their value would be affected by their silver content if the price of silver should rise very much. If the price of silver should rise greatly, which at present does not seem to be very probable, the commodity value of the silver in the coins might become more than their monetary value, and lead to their being melted down, and to their disappearance from circulation. In the case of a country whose currency consists almost entirely of silver money, a rise in the price of silver might place such a country upon a *de facto* silver standard. Most countries have experienced troubles of this kind at some period in their history. In 1920 the price of silver rose so high that the American silver dollar contained a little more than one dollar's worth of silver. Some of the silver dollars were then shipped to the Orient where they were melted down. The price of silver soon declined so that this procedure was no longer profitable. Silver dollars are such a minor factor in the United States currency system that had they all been shipped out, this country would not have been materially affected.

Mexico had an experience of this nature in 1935 that was more serious. In Mexico, silver pesos and smaller coins of silver are widely used. In April, 1935, under the stimulus of the American silver-buying program, silver rose in price to a point where the peso contained more silver than its face value. Pesos accordingly began to be withdrawn from circulation, hoarded, melted down, and exported to the United States. Credit contracted and Mexico experienced a financial crisis. The Mexican Government thereupon closed the banks, called in all the silver pesos, and substituted for them paper and

bronze coins. Subsequently, coins of a lower fineness were issued.<sup>3</sup>

**Production and Price of Silver.**—The largest silver-producing country is Mexico, long famous for its rich silver mines. Mexico is followed by the United States and Canada. The accompanying chart (Figure 10) shows the world production of silver since 1914, and the decline after 1929. The increase after 1933 was due, to a large extent, to the American program of raising the price of silver, thereby encouraging production. Silver is produced today largely in conjunction with other metals, namely, copper, lead, and zinc, so that the production of these metals adds to the production of silver.

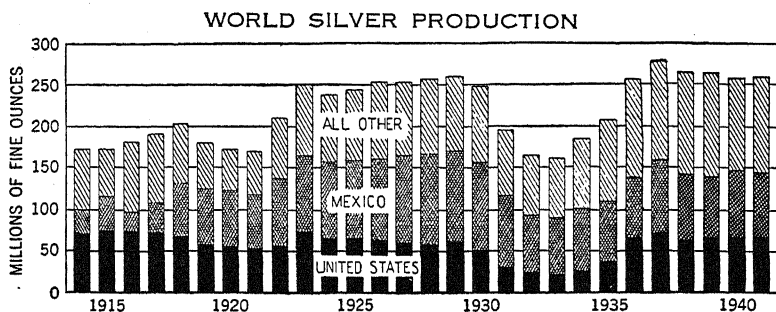


Figure 10. World Silver Production

(Sources: *Annual Reports of the Director of the Mint*; Handy and Harman, *Annual Review of the Silver Market*. Data for 1941 partly estimated.)

The use of silver has been declining for several decades. India, formerly a silver-standard country, was for centuries a substantial user of the metal. Huge quantities of silver found their way to India, and stayed there. A few years ago, however, India became a large exporter of silver, but as a result of the war, again absorbed silver. Because a large part of its currency consisted of silver rupees, India has often been mistakenly referred to as a silver-standard country. The rupee, however, has for many years been a fiduciary coin, like American silver coins.

<sup>3</sup> Mexico is sometimes mistakenly said to be on the silver standard, particularly after the law of July 25, 1931, which declared the silver peso the monetary unit. This law, however, did not introduce the silver standard. It did not provide for the free coinage of silver, and the value of the peso has been independent of the price of silver. The peso has been relatively stable with reference to gold since early 1933, and has been pegged at approximately 4.86 to the United States dollar.

Its value is tied to the pound sterling and not to silver. Since 1927 the Indian Government has been endeavoring to unload on the world market its large and unneeded silver reserve. China, also a major user of silver for centuries, has now become an exporter of the metal, as noted below.

Apart from the gradual abandonment of the silver standard, the use of silver as the material for coins has also declined. As a result of the first World War, paper money came to be used for smaller denominations than formerly, thus narrowing the field for silver. Furthermore, there has been a tendency to use cheaper metals for subsidiary money in place of silver, and to have a lower fineness of silver in coins. The monetary demand for silver has thus declined.

The consumption of silver by industry and the arts prior to 1940 was not large. In 1937 about 17% of new production went into industry and the arts.<sup>4</sup> The film industry has been using increasing amounts of the metal for silver nitrate, but this use does not absorb any large percentage of production. New uses for silver in the electrical field have increased consumption there, but the amounts are relatively minor. New alloys have also been developed, and may be helpful to silver. As a result of the war, however, and the scarcity of all metals, the demand for silver has greatly increased. Silver has been used as a substitute for copper since it is a good conductor of electricity. It is used extensively in the production of aircraft, ordnance and naval vessels. In 1941 the non-monetary consumption of silver by the United States and Canada amounted to nearly one-third of the estimated world production for that year.

In view of the long-term downward trend in the demand for silver, the price of the metal, in terms of gold, has been declining for many years, and in 1931 descended to the lowest point reached in 2,000 years. The price of silver began to decline about 1873, and gradually fell lower and lower, reaching its lowest level at the first of 1933.<sup>5</sup> Early in 1933 the United States Government began to take an interest in silver, and the price rose sharply. In response to American purchases, the

<sup>4</sup> Cf. Handy and Harman, *Annual Review of the Silver Market*.

<sup>5</sup> During the first World War, the price of silver was high.

world price rose from about 25 cents an ounce at the first of 1933 to 81 cents in May, 1935. It was then allowed to decline to about 44 or 45 cents early in 1936, and in 1939 to about 35 cents. The price of newly mined domestic silver has been pegged, as noted below. In August, 1942 the Treasury raised its price for foreign silver to 45 cents an ounce. One of the reasons for this was to encourage the production of Mexican silver.

The price of silver, in terms of gold, has been extremely unstable during the past two decades, gyrations in price having been equaled by those of few commodities. In spite of this instability, several nations attempted to use silver as a currency standard, but all were forced to abandon it.

When an article is produced in too large quantities, the automatic economic remedy is a lower price, which tends to discourage production. Maintaining an artificially high price, as has been done by the United States, stimulates further production. In 1937, world production of silver reached a new high record, 276,000,000 ounces. The previous peak was 261,000,000 ounces in 1929. Production in subsequent years did not quite equal that of 1937.

**Silver in American History.**—The question of silver in the United States, from the economic point of view, would be of no great significance were it not for the political involvement and the consequences of the resulting governmental measures.

The antecedents of the so-called "silver question" in the United States may be traced to 1792, when the United States adopted the bimetallic standard. According to the Act of 1792 both gold and silver could be taken to the mint for coining in unlimited quantities. The ratio between the two metals was fixed at 15 to 1; that is, the mint would accept for coinage fifteen ounces of silver as the equivalent of one ounce of gold. Coins were minted and paid out on this basis. The market ratio between the metals, however, was soon out of harmony with this mint ratio.<sup>6</sup> The result was that the dearer metal, gold,

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<sup>6</sup> In the market one ounce of gold would buy a little more than fifteen ounces of silver.



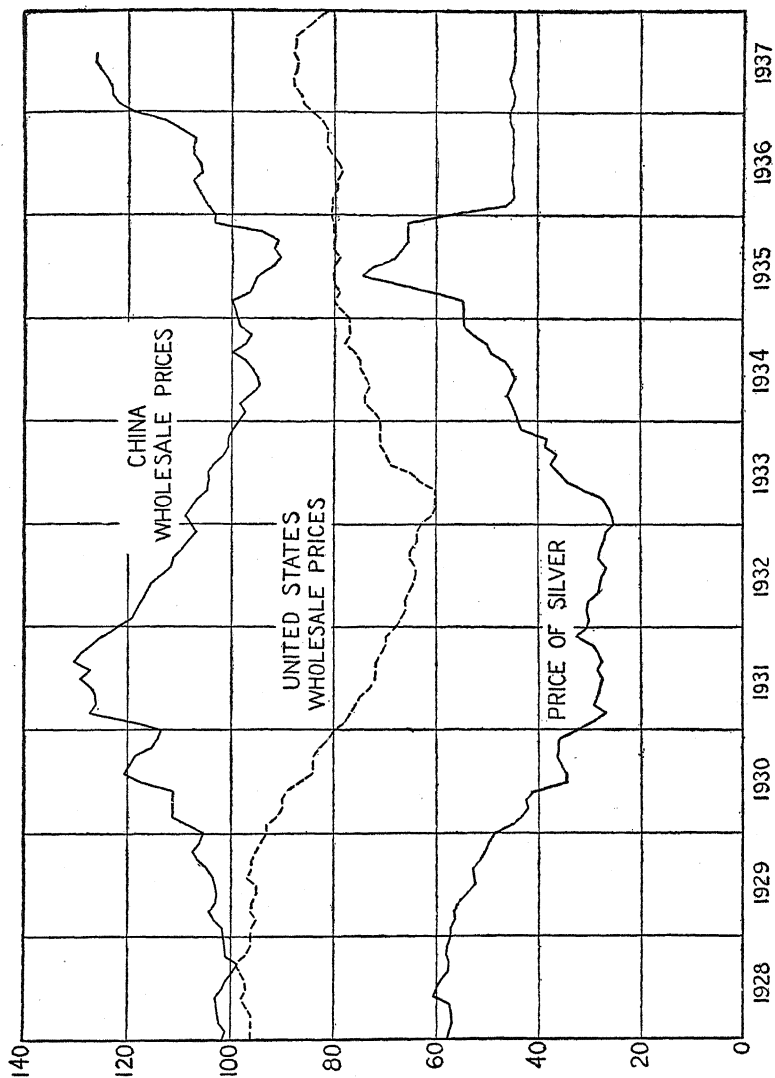


Figure 11. Prices of Silver and Wholesale Prices in China and the United States from 1928 to 1938 (Silver in cents per fine ounce. Price indices 1926 = 100. For China, wholesale prices in Shanghai. For United States, Bureau of Labor Index. Sources: National Tariff Commission, Shanghai; League of Nations, *Monthly Bulletin of Statistics*, B. of L. Statistics.)

disappeared from circulation, and the United States, for all practical purposes, was upon the silver standard.

This situation—legal bimetallism but in practice the silver standard—continued until 1834 when the mint ratio was changed. It was altered again very slightly in 1837, but from then until 1934 continued at 15.988 to 1. This 1837 ratio, however, went too far in the other direction and was above that prevailing in the market. Gold became the cheaper metal, and silver gradually disappeared from circulation. The United States thus, unintentionally and scarcely aware of what was happening, shifted to the gold standard. Legally bimetallism still prevailed. The mints were still open to the free coinage of silver, which was legal tender, but since the market paid a better price for the metal, silver was not brought for coining.

To relieve the scarcity of small change which had developed, silver coins—with the exception of the silver dollar—were reduced in weight in 1853. They thus became token or fiduciary coins. Bullion for these light weight coins was purchased by the government, and the free coinage of silver was abolished—with the exception of that which might be brought for coining into silver dollars. Inasmuch as the amount of silver in a silver dollar cost more than \$1, silver was not brought for this purpose.

The complete and legal departure from bimetallism and the free coinage of silver came in 1873, when an act to revise the coinage laws dropped the silver dollar from the list of coins to be struck. The dollar, however, was the only coin to which free coinage had applied. This omission caused slight comment at the time, since the price of silver had for so long been above the point where free coinage could be availed of profitably. Few persons realized the significance of what was done or were greatly interested. The act, however, closed the mints completely to silver, and was responsible for the widespread silver agitation which began shortly thereafter and has continued intermittently to date. Thus was born the "silver question."

By a strange coincidence, almost immediately after the Act of 1873—later known as the "Crime of 1873"—the price of silver began a long and severe decline in terms of gold, due prin-

cipally to the fact that most of the advanced nations were turning away from silver and adopting gold as their monetary standard. The more the price declined, the louder was the demand in the United States that the government do something in behalf of silver. As a result, the Treasury in 1878 was instructed by the Bland-Allison Act to purchase regularly large quantities of silver and coin it into silver dollars. Although the dollars could not be made to circulate, and the Treasury did not need this silver, the amounts were increased by the Sherman Silver Purchase Act of 1890.

The burden of these measures on the Treasury and the dwindling gold reserve was severe after 1890. The world felt that the United States was going on the silver standard as a result of the inflationary flood of silver money and of paper backed by silver. The ability to redeem all this money in gold appeared uncertain. A financial crisis ensued and the Sherman Act was repealed in 1893 at a session of Congress called for this purpose. This did not end the agitation, and in the election of 1896 silver was the leading issue. Bryan, running on his platform of free coinage of silver at the ratio of 16:1, was defeated, and the gold standard was definitely accepted by the country.

The silver question was quiescent until during the first World War. As the war progressed, Great Britain was increasingly in need of silver to ship to India to pay for supplies purchased in that country. The United States Government had large hoards of silver lying idle in the Treasury, accumulated as a result of the silver purchase measures of the previous century. Great Britain was eager to buy, and after the United States entered the war the Pittman Act of 1918 made this silver available to the British at approximately \$1 an ounce, or about double the market prices of pre-war years. The United States was thus given an exceptionally favorable opportunity to rid itself of its excessive silver.

In the Act, however, was inserted a provision that all silver sold should be replaced by domestically mined silver to be bought subsequently at the fixed price of \$1 an ounce. Consequently, for several years following the war the Treasury found itself buying from American producers silver which it did not

need, at the high price of \$1 an ounce, as compared with the market price of 60 odd cents. For the repurchase of this silver, the Treasury spent a little over \$200,000,000.<sup>7</sup>

**Silver and the World Economic Conference of 1933.**—The price of silver is influenced by currency policies and events in many countries. Silver is produced principally in Mexico, the United States, and Canada, and consumed largely in China, the United States, and India. Its principal market is centered in London. India and Spain are possessors of large stocks of the metal.

When the Government of India in 1927 changed its currency policy and began selling silver in order to build up a gold reserve, and the price of silver accordingly began to decline, objections were raised in various parts of the world—particularly within the United States. The instability in silver was also detrimental to China. As the depression beginning in 1929 grew worse, the price of silver fell lower and lower, and the demands that the United States Government “do something for silver” became more insistent. The Democratic Administration which took office in March, 1933 was pledged in its platform to “an international monetary conference called on the invitation of our Government to consider the rehabilitation of silver and related questions.”

The movement for international cooperation to rehabilitate silver culminated in May, 1933, when Senator Key Pittman of Nevada announced that all the countries participating in the discussions at Washington preliminary to the World Economic and Monetary Conference—arranged for during the Hoover Administration and about to convene in London—had agreed in principle upon plans regarding silver. This announcement coincided with joint statements issued by the President and by the Mexican and Chinese Ministers of Finance, expressing a favorable attitude toward enhancement and stabilization of the price of silver.

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<sup>7</sup> In addition, the Senate in 1924 instructed the Treasury to buy 14,590,000 ounces more at \$1 an ounce, because some of the Treasury's silver had been used for subsidiary coins.

The principal purpose of the conference was to stabilize currencies and exchange rates, and to free trade from some of the numerous restrictions that handicapped it. Although the conference as a whole was a failure, as discussed in Chapter 31, it passed a resolution on silver. The resolution, introduced by the United States delegation, was approved unanimously by the delegates of the 66 nations, July 20, 1933. It recommended that nations using, producing, or holding silver make an agreement with a view to mitigating the fluctuations in the price of silver; that the nations refrain from further debasement of silver coinage, and that they substitute silver for low value paper currency.<sup>8</sup>

The agreement recommended in the resolution was signed outside the conference a few days later, July 22, 1933, by representatives of eight nations—the United States, Canada, Mexico, Australia, and Peru (silver producers), and India, China, and Spain (holders of silver). The agreement provided among other things that India limit her annual sales of silver, and that other nations withdraw from the market annually a certain amount of their mine production.<sup>9</sup>

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<sup>8</sup> The resolution reads:

"BE IT RESOLVED TO RECOMMEND TO ALL GOVERNMENTS PARTIES TO THIS CONFERENCE:

"A.—That agreement be sought between the chief silver-producing countries and those countries which are the largest holders or users of silver with a view to mitigating the fluctuations in the price of silver, and that other nations not parties to this agreement should refrain from measures which could appreciably affect the silver market;

"B.—That Governments parties to this Conference shall refrain from new legislative measures which would involve further debasement of their silver coinage below a fineness of 800–1,000;

"C.—That they shall substitute silver coins for low-value paper currency insofar as the budgetary and local conditions of each country will permit;

"D.—That all provisions of this resolution are subject to the following exceptions and limitations:

"Requirements that such provisions shall lapse April 1, 1934, if the agreement recommended in paragraph A does not come into force by that date, and in no case shall they extend beyond Jan. 1, 1938.

"The Governments may take any action relative to their silver coinage they deem necessary to prevent the flight or destruction of their silver coinage by reason of a rise in the bullion price of the silver content in their coin above the normal or parity value of such silver coin."

(*Commercial and Financial Chronicle*, July 29, 1933, p. 777.)

<sup>9</sup> The agreement reads:

"Whereas, the Governments of India and Spain may desire to sell a certain portion of their silver holdings and it would be to their advantage that the countries which are large producers of silver should absorb silver as herein provided to offset such sales; and

Whereas, It is to the advantage of the large producing countries named in

Neither the resolution nor the subsequent agreement made any mention of raising the price of silver. On the contrary, the agreement was made "with a view to mitigating the fluctuations in the price of silver, and that other nations not parties to this agreement should refrain from measures which could appreciably affect the silver market." The subsequent silver measures of the United States, sponsor of the agreement, were hardly in harmony with this aim of stabilization and the avoidance of measures which would "appreciably affect the silver market." Beginning in 1936, however, the United States did stabilize the price of silver.

In the President's Proclamation of December 21, 1933, regarding the purchase of domestically mined silver, he announced that he had ratified the above agreement. India, he stated, had already put the agreement into effect. Of the 66 nations that agreed unanimously to the resolution, the majority did not produce any silver and were not much interested in silver. Many

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Article II that the sales of silver from monetary stocks should be limited as herein provided; and

"Whereas, It is to the advantage of China that the sales from monetary stocks of silver be offset by the purchases as herein provided with a view to its effective stabilization:

"Now, therefore, it is agreed between the parties hereto:

#### I

"That the Government of India shall not dispose by sale of more than 140,000,000 fine ounces of silver during the period of four years commencing Jan. 1, 1934. Disposals during each calendar year of the said four-year period shall be based on an average of 35,000,000 fine ounces per year.—

#### II

"That the Governments of Australia, Canada, the United States, Mexico, and Peru during the existence of this agreement shall not sell any silver and shall also in the aggregate purchase or otherwise arrange for withdrawing from the market 35,000,000 fine ounces of silver from the mine production of such countries in each calendar year for a period of four years commencing with the calendar year 1934. Said Governments undertake to settle by agreement the share in said 35,000,000 fine ounces which each of them shall purchase or cause to be withdrawn.

#### III

"That the silver purchased and withdrawn in accordance with Article II above shall be used for currency purposes (either for coinage or for currency reserves) or be otherwise retained from sale during the said period of four years.

#### IV

"That the Government of China shall not sell silver resulting from demonetized coins for a period of four calendar years commencing Jan. 1, 1934.

#### V

"That the Government of Spain shall not dispose by sale of more than 20,000,000 fine ounces of silver during the period of four years commencing Jan. 1, 1934."

(*Commercial and Financial Chronicle*, July 29, 1933, p. 777.)

had no silver coins in circulation, but used nickel, copper, or bronze for minor coins and paper for larger denominations. Others had only small amounts of silver in their coins because of a reduction in the silver content of the coins. Few of the countries were buyers or potential buyers of silver.

Several of these countries, however, possessed large stocks of silver which they were desirous of selling. The producers of silver, such as Australia, Canada, Mexico, and Peru, were, of course, willing to support the United States in plans to prevent further dumping of silver hoards on the world's markets and to bring about an absorption of part of the silver output.

China, as the only large nation on the silver standard, desired stabilization of the price of the metal. The drastic declines in price which had taken place had been upsetting to China's foreign-exchange rates and trade. It was China's hope that a checking of the sales of silver from India and elsewhere, and the absorption of silver by the United States, would halt the decline and thereby benefit China. The sharp and extensive rise in price, maneuvered by the United States and which was so disastrous to China, was certainly not desired, as can be seen by the discussion below.

**United States Silver Measures Since 1932.**—During the first part of 1929 silver began its long descent which carried the price to unprecedentedly low levels. The decline accompanied a drastic fall of commodity prices in general, but was also caused by fundamental changes regarding silver itself—particularly currency changes in India and the dumping of large quantities of Indian silver on the market. As the price of silver declined, agitation in the United States in behalf of the metal increased.

Due to the increasing severity of the economic depression during 1930, 1931, and 1932, proposals aimed to aid the silver industry obtained the support of sponsors of currency measures advocated as remedies for the business and financial disturbances. Inflationary demands from people not particularly interested in silver harmonized with proposals that the silver element in our currency be broadened, and even that the mints be reopened to the free coinage of silver.

With the continuance of the depression many came to feel that the monetary and credit mechanism of the country should be expanded to check the devastating deflation. This could have been done, of course, without any reference to silver. Trade with China had been disturbed by the falling price of silver, and advocates of a silver subsidy in America advanced the idea that China's purchasing power would be increased by higher prices for silver, and that this would also benefit the United States. A flood of proposals involving silver were brought forward and actively discussed. The silver measures finally adopted by the Roosevelt Administration followed on the heels of these strong demands.

The first important measure taken in behalf of silver was the Act of May 12, 1933. This Act, among other things, empowered the President to adopt bimetallism and open the mints to unlimited coinage of silver at practically any ratio to gold that he wished. He was also given the power to alter the weight of the silver dollar—as well as that of the gold dollar—and to receive war debt payments in silver.<sup>10</sup> Under authority of this Act, the President in December, 1933, announced that the Treasury would purchase all newly mined domestic silver at a price of 64.64 cents an ounce. The market price was then about 43 cents.

The administration's most far-reaching action with respect to silver was the Silver Purchase Act of June, 1934. This declared it was the policy of the United States to increase this country's silver stocks until they equaled one-third of the gold stocks. The Secretary of the Treasury was accordingly instructed to purchase silver at home or abroad until this objective was attained, or until the price of silver exceeded \$1.29 an ounce. He was given discretion in regard to the time and manner of purchase, and prices to be paid. Silver certificates were to be issued against the newly acquired silver to an amount equal to not less than the cost of the metal.

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<sup>10</sup> Under this provision, 22,735,000 ounces of silver were received from foreign debtor governments and credited to them at 50 cents an ounce. The market price at that time was about 34 cents. This silver was received on account of war debt payments due in June, 1933. No other payments were made, apart from \$6,000 paid by Latvia.



This act was followed in August, 1934, by a Presidential order nationalizing silver, and requiring delivery to the government of all silver in the United States, with exemptions for certain classes. The price paid by the Treasury was 50.01 cents an ounce. This order was revoked in April, 1938. The next governmental silver measure came in April, 1935, when the price to domestic producers was raised until it finally reached 77.57 cents an ounce. In December, 1937, the President extended the arrangement for the purchase of domestic silver to December 3, 1938, and also reduced the price to 64.64 cents an ounce. In December, 1938 he continued this price until July 1, 1939. According to an act of Congress, July 6, 1939, the Treasury was required to buy domestic silver at a price of 71.11 cents.

The silver policy of the Roosevelt Administration has expressed itself most conspicuously in the purchase of large quantities of silver, both at home and abroad, and in the payment of prices for this metal considerably in excess of those which would have prevailed had silver been allowed to seek its own level. The excess paid has amounted to a substantial subsidy to American silver producers, and also to foreign sellers of silver.

The intention of the Silver Purchase Act as stated therein was that silver should be acquired until one of two things happened—either silver stocks should have been raised to the point where they were one-third of the value of the gold stocks (silver to be computed at its coinage value of \$1.29 per ounce), or the price of silver should be in excess of \$1.29 an ounce. Gold stocks in the country at that time amounted to about \$7,800,000,000 (devalued dollars). On this basis there needed to be acquired additional silver to the extent of about \$1,700,000,000 (monetary value), or a little over 1,300,000,000 ounces, compared to the approximately 700,000,000 ounces already held. This was the expensive goal set at that time by the Act. Since then, matters have changed in that huge gold importations have increased the additional silver needed. At the end of 1941 Treasury holdings of silver amounted to approximately 3,280,000,000 ounces,<sup>11</sup> but gold stocks had risen to \$22,737,000,000,

<sup>11</sup> Handy and Harman, *Annual Review of the Silver Market*.

so that silver stocks were only about 16% of the combined total value rather than the required 25%.

From the currency standpoint, the silver accumulated by the Treasury serves practically no useful purpose. For many years the Treasury has possessed excessive amounts of silver. Since this country is not on the silver standard, a silver reserve is of no more use than would be a hoard of any other commodity, such as copper or wheat. Gold reserves do not need assistance from silver even if this were possible—which it is not unless the country should adopt bimetallism.

In spite of the intense war demand for metals, including silver, and the shortage of silver for industrial uses, large amounts of silver are lying idle in the Treasury's vaults. In the fall of 1942 approximately 1,550,000,000 ounces were tied up behind silver certificates. The "free silver," about 1,350,000,000 ounces, was made available for "lend-lease" to industry through the Defense Plant Corporation, but this silver must not be used in any way which prevents its subsequent return to the Treasury. In September, 1942 only about 12% of the "free silver," therefore, had been transferred in this manner. Strong demands were made, especially by the jewelers, for repealing the silver legislation.

**Purchase of Foreign Silver by the United States.**—In order to carry out the purposes of the Silver Purchase Act, the Treasury needed to acquire foreign silver, inasmuch as domestic silver production is not adequate to build the silver reserve to one-third of the gold reserve. Accordingly, the Treasury bought large amounts of silver abroad, particularly in London, where the world silver market centers. London bullion brokers, known as the "four just men" meet and fix the price of silver each day after all offerings and bids are received. The price is one which they believe will clear the market. All sales are to be consummated at the price for the day. Since the Treasury was the principal buyer, its bid was ordinarily accepted as the quotation for the day—until the Treasury suddenly stopped buying in December, 1935.

Under the stimulus of Treasury buying, the price of foreign silver rose in the spring of 1935 to a point where it exceeded the price being paid to domestic silver producers. The domestic price was consequently raised, as already noted. The effect was to encourage foreign speculators, who believed that the Treasury would push the price higher and higher. In December, 1935, the Treasury suddenly withdrew from the foreign market, and the price of silver dropped abruptly, with repercussions in many countries. In January, 1936, the price of silver was allowed to decline to about 45 cents, and in 1939 to about 35 cents. In August, 1942 it was raised again to 45 cents.

In January, 1936, the Treasury announced that it had concluded an agreement with Mexico, whereby the Treasury would acquire through the Bank of Mexico practically all of the newly mined Mexican silver. Announcement was made in March, 1936, regarding a similar arrangement with Canada. In May, 1936, the Treasury stated that an agreement had been reached with China whereby substantial purchases of silver were to be made, and the proceeds used to help stabilize China's currency. This agreement was reaffirmed in July, 1937, and announcement made that China would secure additional gold in exchange for silver. The agreement with Mexico was renewed in January, 1938, but in March purchases of silver from Mexico were halted following the expropriation of American oil properties by the Mexican Government. Purchases were soon resumed on a day to day basis, and in November, 1941 another agreement was entered into.

**Silver in China's Economy.**—In China, until recently, money consisted very largely of silver and, conversely, silver, even in bullion form, was money. Copper coins were used by the great mass of the people for small purchases, but silver constituted the principal monetary standard and was used for most purchases of any size.<sup>12</sup> It was the metal used by banks for reserves, and was hoarded by persons fortunate enough to possess it.

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<sup>12</sup> For a discussion of the different currency standards prevailing in China, cf. Frank Whitson Fetter, "China and the Flow of Silver," *The Geographical Review*, January, 1936.

As the American silver program got under way and the Treasury offered higher and higher prices, China saw its money depart for the United States. China had normally been a silver-importing nation—a buyer and not a seller of the metal—absorbing large quantities in exchange for tea, silk, and other goods. Silver stocks in Shanghai declined from about 440,000,000 ounces at the end of 1933 to 257,000,000 in March, 1935.<sup>13</sup> Its exodus meant a contraction of the country's currency supply and left closed banks, severe depression, bankruptcies and stagnant trade.<sup>14</sup>

China went through an inflationary boom from about 1926 to the latter part of 1931, due principally to large accumulations of silver in the reserves of the banks and to the cheapening of the metal throughout the world. Silver came to Shanghai from the interior for protection and because business was dull due to political disturbances. Silver also came in from abroad. In Shanghai silver stocks had increased from about 101,000,000 ounces in January, 1926, to 449,000,000 in June, 1934. As a result, money was plentiful and commodity prices rose in China.

Figure 11 shows the course of commodity prices in Shanghai—which reached a peak in 1931—and the fall that took place from then until 1935. It shows also the world price of silver, and commodity prices in the United States during that period. It will be noted that commodity and silver prices in China tend to move inversely.

China, with rising commodity prices, enjoyed prosperity when the gold standard world was suffering from falling prices and depression. Although prices abroad were low, China was able to sell outside its borders because foreign gold values could be converted into a large amount of Chinese currency at favorable exchange rates due to the cheapening of silver in terms of gold.<sup>15</sup>

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<sup>13</sup> Handy and Harman, *Annual Review of the Silver Market* for 1935.

<sup>14</sup> Complete silver export figures are not available, since a large amount of silver was smuggled out of China.

<sup>15</sup> The fall in the price of silver, in terms of gold, in 1929, 1930, and 1931 also contributed to the rise in commodity prices in China by making foreign goods more expensive. Exchange rates on gold countries rose as silver fell, and thus made foreign goods more costly in China. To most of the world, silver was merely

The commodity price level in China stopped rising and began to decline in the fall of 1931, as can be seen in the chart. This decline coincided with Britain's departure from gold in September of that year. The pound sterling promptly depreciated abroad and the price of silver, which had already stopped falling, turned upward. The rise in silver was short-lived, but its long decline had come to an end and, with it, the boom in China. The ending of silver's decline was due primarily to prospects regarding American assistance to the metal and to the halt of commodity price declines in Britain once that country left gold. Commodity prices throughout the gold standard world, however, continued downward for another year. This change in the trend of Chinese commodity prices marked the end of inflationary prosperity there. A downswing of business in China was thus in process when the United States started actively to boost silver. As the price of silver rose, China's depression became increasingly severe. Falling silver had been unhealthily stimulating to China, and an ending of the decline ended the prosperity. The rising price of silver, on the other hand, had depressing effects. As it continued, it led to severe economic disorders; banks saw their cash reserves depleted by withdrawals of the metal for shipment abroad. As large reserves had financed the boom and rising prices, so reduced reserves and a contraction of the currency spelled deflation, falling prices, and depression. While the American silver program cannot be blamed for originating the depression in China, nevertheless a rising silver price was the principal factor responsible for China's grave economic troubles after early 1933, culminating in the breakdown of its currency system.

It had been contended in the United States that a rise in the price of silver would stimulate sales to China by increasing the value of China's money in terms of United States dollars and other foreign currencies. These expectations, denied by econo-

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a commodity and its price fell along with those of other commodities, in fact, fell more rapidly than most. Figure 11 shows how silver fell from 60 to 27 cents an ounce during the period when commodity prices in the United States were falling from about 98 to 75 (and then to 60). In China, where silver was used as a currency unit to measure values, this greater fall of silver—a cheapening of silver in terms of foreign commodities—meant that foreign goods cost a larger amount of silver. Domestic prices within China, however, had been rising due largely to the inflationary movement.

mists, were not borne out by later experience. Exchange rates in China on foreign countries began to rise in 1933, along with the rise in silver. In 1933 there were 28.60 American cents to a Chinese yuan; in 1934, 34.09. This rise in exchange rates, instead of helping China's trade, proved very disturbing. Chinese exporters found their sales yielding less in Chinese money, so that exports were discouraged. Importers, on the other hand, were unable to sell as much as formerly, although foreign goods became cheaper as silver rose. They sold less because of depressed conditions within China and the reduction of the people's purchasing power which accompanied the drastic deflation. Foreign trade thus declined sharply.

In 1935 China's total foreign trade, according to League of Nations figures, amounted to only about 66% of the 1931 level.<sup>16</sup> The loss was evenly divided between exports and imports, exports being 65.26% of the 1931 level and imports, 66.66%. While trade between the United States and most of the world increased after 1933, this country's trade with China declined, due principally to the severe economic disturbances within China, which in turn were attributable in large measure to high-priced silver. Foreign trade is aided by exchange rate stability, and damaged by wide fluctuations such as took place when China's currency was tied to silver.

**China Abandons Silver Standard.**—As the American silver program progressed, China became increasingly fearful of its effects upon her economy. The Chinese Government early protested to the United States Government. In February, 1934, Dr. H. H. Kung, Minister of Finance, informally brought to the attention of the United States Government the probable detrimental effects upon China of the projected rise in the price of silver. On August 19, the following communication was sent to President Roosevelt by Minister Kung:

"The London Silver Agreement of July, 1933, received the signature of China's representatives and has more recently been ratified by the National Government of the Republic of China

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<sup>16</sup> League of Nations, *Monthly Bulletin of Statistics*.

with the understanding that its major purpose was to assure the stability of the price of silver which was thought menaced by the large surplus stocks held by the Governments of India and Spain. The preamble of the Agreement states in part that 'it is to the advantage of China that sales from monetary stocks of silver be offset by purchases as herein provided, with a view to its effective stabilization.'

"It now appears that under the Silver Purchase Act of 1934 the stability of the price of silver and the interests of China are as much menaced as by the previous situation of potential sellers. China would therefore appreciate an indication of the probable policy of America in the future purchase of silver in order that China may properly safeguard her currency, which has recently been flowing out of the country to a degree that is potentially alarming."<sup>17</sup>

The reply of the United States, dispatched September 22, after referring to this government's policy of increasing its holdings of silver, said that the government was thus endeavoring to expand the monetary use of silver as recommended by the resolution adopted in London.

On the next day, September 23, 1934, Minister Sze sent a communication to the United States Government outlining the severe economic disturbances and dislocation of affairs which the American silver policy was producing in China. The note said that China was obliged to consider changing the country's currency system, and the gradual adoption of a gold-basis currency.

To this communication the United States Government replied, October 12, 1934, that the silver buying program was embodied in an act of Congress and was mandatory upon the Executive. It continued: ". . . this Government, while necessarily keeping within the general purpose of the enactment, will give the closest possible attention to the possibilities of so arranging the time, place and quantity of its purchases as will keep in view the considerations put forward by the Chinese Government in its communications."<sup>18</sup>

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<sup>17</sup> Kuo Min News Agency, October 16, 1934.

<sup>18</sup> *Ibid.*, October 14, 1934.

China became convinced that it could expect no relaxation of the aggressive American policy, which was playing havoc with its economic affairs. On October 15, China endeavored to stem the outflow of silver, halt further appreciation of the Chinese silver dollar and stay the depression by imposing an export levy of 10% upon exportation of silver plus an equalization charge that varied with the price of silver. By this measure the Chinese currency was separated from the price of silver, and exchange rates no longer fluctuated with every change in silver. The measure helped somewhat, but was not entirely effective because of the difficulties of enforcement.

The price of silver continued to rise. At the time of the above communications in the fall of 1934, it was around 50 cents an ounce, while in May, 1935, it rose to 81 cents. Silver was smuggled out of China in spite of government restrictions. China's problem thus continued acute. The silver standard was finally abandoned on November 4, 1935, when a managed currency was substituted for China's historic standard. The British colony of Hong Kong took similar action.<sup>19</sup>

China's action dealt a severe blow to silver, since China for generations had absorbed large quantities of the metal. It

<sup>19</sup> In announcing the change Minister of Finance H. H. Kung, after recounting the disturbances suffered by China and referring to his country's efforts to check the outflow of silver, said:

"It was, however, clear at the outset that the measure adopted could only be temporarily effective; as long as the value of the currency remained high, deflation would continue and with increased severity; should the value fall and create a wide disparity between the domestic and foreign price of silver—as in fact has happened—extensive smuggling of silver would result.

"In order to conserve the currency reserves of the country and to effect lasting measures of currency and banking reform, the Government, following the precedents of many countries in recent years, has decreed, with effect from November 4, 1935, as follows:

"1. The banknotes issued by the three Government banks, . . . shall be full legal tender. . . . The notes of all other issuing banks . . . will gradually be withdrawn . . . their bank note reserves are to be deposited with the Central Bank.

"2. All debts expressed in terms of silver shall be discharged by the payment in legal tender notes of the nominal amount due.

"3. All holders of silver are required to exchange their silver for legal tender notes.

"4. The exchange value of the Chinese dollar will be kept stable at its present level, and for this purpose the Government banks will buy and sell foreign exchange in unlimited quantities.

"The Government-owned Central Bank is to be reorganized as the Central Reserve Bank of China . . . devoting itself chiefly to maintaining the stability of the nation's currency. . . . After a period of two years (it) will enjoy the sole right of note issue."

(Currency Reserve Board, *The Monetary Policy of China*, Shanghai, January 15, 1936.)



brought to an end, at least for the present, the long history of silver as a currency standard. It also left the United States Treasury the principal buyer of a metal which other nations did not want. China had wished to leave silver for several years and had been making plans in this direction, but the American silver program compelled the step.

At the request of the United States, representatives of the Chinese Government conferred in Washington with the United States Government in April, 1936, regarding the silver program.<sup>20</sup> On May 18 announcement was made that an agreement had been reached whereby the United States would purchase considerable amounts of silver from China. The American dollar proceeds were to be maintained chiefly in New York and were to be available to assist in the stabilization of China's managed currency. In July, 1937, this agreement was reaffirmed, and announcement made that additional gold would be given China in exchange for silver. The United States had on two previous occasions purchased large amounts of silver from China which were helpful to China.<sup>21</sup> Ambassador Sze issued a statement, also given out in Shanghai, in connection with the 1936 agreement, which declared that China's currency was to be independent and not linked to any foreign unit. Great Britain, it was reported, had been endeavoring to have the Chinese yuan linked to the pound.

China's managed currency functioned satisfactorily, but had existed less than two years when the country was attacked by Japan. In spite of this disaster and the fact that several of China's principal cities, including the financial center, Shanghai, were occupied by Japanese troops, the stability of the currency was maintained for a considerable period. Exchange rates on New York remained at a little over 29 cents per yuan, China having acquired substantial currency reserves abroad, until the spring of 1938 when the rates sagged.

As the war continued and spread over more and more territory, the currency depreciated considerably, reflecting the critical

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<sup>20</sup> *New York Times*, April 8, 1936.

<sup>21</sup> In November, 1934, 19,000,000 ounces and in November, 1935, 50,000,000 were bought. *New York Times*, May 19, 1936.

situation and inflation which China was unable to avoid. By the summer of 1942 inflation had become serious and prices in Chungking were approximately 60 times higher than in July, 1937 when the war started.

PART IV  
INTERNATIONAL ECONOMIC POLICIES



## CHAPTER 25

# THE TARIFF QUESTION; PROTECTION AND FREE TRADE

**Purposes of Tariffs.**—The tariff question for several generations has unfortunately been so involved with politics that much of the thinking upon the subject has been confused. Particularly in the United States has the matter become a political issue, tending to obscure the economic aspects. Protective tariffs are financially lucrative to special groups of people, groups often with large resources and willing to spend time and money convincing legislators that the prosperity of the country depends upon high protective tariffs. In order to understand the effects of tariffs, the subject should be approached with a scientific attitude, free from prejudice and preconceived ideas.

Tariffs are levied principally for two purposes. They are levied to yield revenue to the government and to protect the home producer against competition of foreign producers, that is, to keep out foreign goods and probably raise the domestic selling price of these goods. These purposes may be combined, since the same tariff yields revenue and also affords protection. A tariff for revenue purposes only, however, would be a different kind of tariff than a protective tariff. It would be levied upon different commodities, and the rates of duty would be different. Oftentimes a lowering of the rates, affording less protection and permitting greater imports, would provide more revenue. Even though the rates were lower, the larger quantities of goods imported might cause the total revenue to be greater.

The origin of tariffs may be traced to a desire upon the part of the state or sovereign for revenue. Foreign goods were considered to be desirable objects for taxation, since the foreigner was not present to object. Furthermore, he was a "foreigner,"

and had no rights. The idea of hostility toward foreigners is still reflected in the attitude of many people toward foreign commodities. "Buy British" and "buy American" are supposed to be patriotic slogans. If an article is produced outside the borders and is obtained by trading our own goods for it, it is not supposed to be as meritorious a purchase as though we produced it ourselves. A tax upon foreign goods, levied for revenue purposes, almost inevitably discourages importation of the goods, and thereby yields incidental protection to domestic producers. The protective purposes of tariffs therefore often developed out of the levying of duties for revenue.

Today, tariffs are only one means of keeping out foreign goods and protecting the domestic producer. What is said here about the effects of tariffs applies, therefore, in general to other restrictions on trade.

Tariffs are usually beneficial to certain few people but not to everyone; there is a conflict of interest. On one side we have producers who find themselves in competition with foreign-produced goods. They are protectionists, are organized, and often financially strong, maintaining lobbyists and seeing their objectives clearly. On the other side is the general public, unorganized, and not understanding its own interests. From the economic standpoint tariffs are, with a few exceptions, harmful to the people or nation as a whole, although in some cases beneficial to certain groups of people—those groups that receive incomes from protected industries.

A tariff ordinarily keeps out foreign goods that would otherwise be imported, and enables the domestic producer of the article on which the duty is levied probably to raise the price. The buying public is therefore compelled to pay a higher price than would otherwise be the case. The question is, are there offsetting advantages which justify this granting of special favors to certain producers at the expense of the general public? The answer, in brief, is that under certain special circumstances a tariff may be legitimate from the national standpoint and may benefit the nation as a whole, but that such cases are not very numerous. In the great bulk of cases there is a net loss, as explained below.

Furthermore, the higher prices which the public is compelled to pay for foreign goods do not measure the entire loss suffered. In addition, there is the loss involved in foregoing consumption of goods that are not imported. This loss is not revealed by the extra price which the public must pay on those goods that are imported. Perhaps only very few goods are imported and consumed because of the high duties. Furthermore, the prices of domestic goods are raised by a tariff, so that the public pays higher prices for these as well as for the foreign goods. The gain to domestic producers, moreover, is in the long run not as great as might at first appear; in fact, in many cases there is no gain at all except temporarily. Evidence of this is the fact that many protected industries are chronically in distress and barely able to show a profit. The capital invested would be better rewarded if placed in other fields where the country has better advantages.

**Advantages of Free Flow of Trade.**—The advantages which result from trade between individuals or between the different nations have already been discussed. They include the advantages which come from specialization and the division of labor. Through trade it is possible for people to have more and better commodities than if they were dependent upon their own direct efforts. Trade also makes possible large-scale production, the utilization of elaborate and expensive equipment, and all the economies that go with this type of production. It permits the location of plants in favorably situated areas, specialization, the acquiring of skill, and more efficient utilization of abilities and resources.

A large and growing trade, it will be noticed, indicates progress, advancement in productive methods, increasing economy in the use of resources, and a better division of labor with a resulting larger output. It leads to more commodities to consume and a higher standard of living for everyone. It means that there is less attempt to grow wheat on poor wheat land, and to produce steel where there is a lack of plentiful supplies of ore, coal, and other essentials. The law of comparative advantage teaches that nations tend to produce articles in the production

of which they have special advantages, or in which they have the least disadvantages. A large and growing trade, unhampered by restrictions, indicates that special advantages are being utilized, and that the country is tending to make the most of its opportunities.

Trade, therefore, represents progress; it is to be encouraged and the way made as easy as possible. This applies to all trade, domestic as well as foreign, and to imports as much as to exports. For every sale there must be a purchase; every export is also an import for some nation. There are economic limits to the amount of governmental help which can be economically given to further trade. Most countries tend to emphasize the development of exports—governments frequently spending large sums to stimulate exports—as though something especially desirable pertained to exports as opposed to imports. An understanding of the two-sided nature of trade and the balance of payments makes it clear that exports cannot take place without imports, and vice versa. The facilitation of imports is just as helpful to a country as the facilitation of exports.

The present state of mind in most countries regarding exports is a relic of mercantilism. It is due partly to the fact that the industrial and business leaders of a country generally have a greater financial interest in exports than in imports. It is also true that at times the maintenance of currency and foreign-exchange stability is assisted by a healthy export trade, and by a decline in imports or other debit transactions. An excessive amount of debits in a country's foreign transactions may tend to upset the currency and foreign exchanges. On the other hand, an excessive amount of credits may also upset exchange rates, altering the equilibrium level. This subject is discussed in Part II.

The advantages of allowing trade to develop along natural lines, permitting each region to produce those things which it is best fitted to produce, and which it will tend to produce if given a chance, are illustrated by the large and efficient production within the United States, where 132,000,000 people, living over an expanse of 4,000 miles, produce and trade with each other without the handicaps of trade barriers. Production in



the United States has been allowed to become highly specialized. Automobiles are made in Detroit and the neighboring territory, steel in Pittsburgh, Chicago, and other centers, and shoes in New England, New York, and St. Louis. The high per capita production in the United States and the high standard of living are, of course, not to be attributed entirely to freedom of trade among the states, but this freedom, along with the help of a common currency, and other conditions which facilitate trade, is an exceedingly important factor.

If it is desirable economically for California to trade freely with New York and Massachusetts, and for Oregon to trade with Pennsylvania, it should be equally desirable for these states to trade with Canada, England, France, Brazil, and other countries. Trade between two or more people brings a net gain to both parties, whether the people are neighbors or live on opposite sides of the earth. To reduce imports by a tariff or other restrictions is to reduce exports also, and therefore to reduce the gains of trade. Exports are merely a means of acquiring the commodities imported more easily than producing them at home. If Texas had remained a part of Mexico, the protective tariff philosophy would teach that the United States should restrict its trade with Texas; but since this state is part of the United States, trade with Texas is free. Trade, if left alone, follows economic lines and pays little attention to what flag flies, unless forced to do so by artificial barriers.

**A Tariff on Military Essentials.**—While most of the popular arguments for protection have no sound economic basis, a tariff for protective purposes is in a few cases defensible. Although most tariffs are harmful, often the result of lobbying and contributions to the political party chest, nevertheless, a protective tariff may under certain circumstances be considered to be legitimate.

Military necessity may make desirable the imposition of a tariff upon certain essential commodities which a country lacks and which would be necessary in the event of a war. A nation which has little or no steel industry might desire to build up such an industry as a matter of military preparedness. The

United States upon the outbreak of the first World War found itself without much of a chemical industry. Chemicals had been imported from Germany, since Germany excelled in this field, and American chemicals were usually inferior. In modern warfare chemicals play such an important part that the protection to the American chemical industry embodied in the tariff enactments may be legitimately defended. It is, of course, futile for a nation to attempt to be self-sufficient in all respects regarding the conduct of a war, but there are certain essential articles, such as munitions, food, and ships, which a nation may wish to possess without depending upon foreign nations. The list of articles, however, which are war necessities has grown with the change in the nature of war. The economic loss as a result of providing protection for military necessities is to be considered similar to the expense of maintaining military establishments. A tariff for military purposes is a burden upon the country, and although it may be a necessity is to be regarded as an unfortunate necessity.

The United States during the first World War was woefully lacking in ships, and had it not been for the ships of Great Britain, France, and Italy, would not have been able to get men to France or to have maintained them there. The United States, therefore, determined to have a merchant marine of its own even though shipping is not an industry in which the United States excels. The country's efforts can apparently be more profitably utilized in other fields. In order to keep the American flag on the seas, the United States has been subsidizing its shipping in various ways, as discussed in the chapter on the "American Merchant Marine."

**Protecting New Industries.**—Another circumstance which might justify a protective tariff is that which often confronts a new or backward country. A country may have natural advantages along certain lines but be unable to get started in those lines because of strong foreign competition, competition from industries which are already going concerns. In such cases a protective tariff may be helpful. This is sometimes known as the young or infant industry argument for protection. The

early tariffs in the United States were urged for this reason. Alexander Hamilton favored moderate duties so as to encourage the development of manufacturing. Our manufacturing industries encountered severe competition from British industries, especially after the War of 1812, and found difficulty in getting a foothold.

The economist Friedrich List, who settled in the United States in the eighteen twenties after having been expelled from the German parliament because of his ideas which were then regarded as radical, saw the difficulties young American industries were encountering from competition with established foreign companies. He favored moderate duties to help these young industries. He believed, however, that the duties should be low, not over 25%, lest they encourage industries unsuited to the country. He also said, which is most important, that the duties should be temporary, that they should not last more than 20 to 30 years, and that if an industry could not by that time compete with foreign goods it should not be fostered. He recognized an immediate loss from protective tariffs but felt that ultimately the country would gain by having industries of its own, ones naturally suited to the country. List, in 1832, carried his ideas back to Germany where he saw a similar situation in that industrial development there was in its infancy and handicapped by established foreign industries. Germany was not a "young" country, but was, however, in a period of transition to modern conditions.

China, prior to the attack by Japan, was in this same position, desiring to have some industries of its own, yet finding their establishment difficult because of foreign competition. While the tariffs in China were primarily for revenue purposes, they were also intended to encourage the development of certain industries. The war, of course, interfered with this program. Most nations desire a certain amount of industrialization in the interests of diversification and to expand production, especially when the country seems suited to industries. A protective tariff facilitates the desired transition. As a result of the war, industrialization has been stimulated in Latin America. This took place without high protection.

A tariff to protect young industries and foster their growth should ordinarily not be applied to agricultural products or to raw materials. The geographical location of these is controlled by physical conditions, and their exploitation is not seriously handicapped by the fact that foreign production is already established.

The situation which List saw in the United States 100 years ago and that which exists here now are totally different. The United States is no longer a weak country struggling to develop its industries. American industries are no longer infants but are of tremendous size and as strong as any the world has ever seen. Most of them need no protection in order to compete successfully with foreigners, as evidenced by the country's large export trade. The few industries that do need protection in order to live are because of that fact unsuited to this country, which indicates that they should never have been fostered. The United States, therefore, is wasting its energies when fostering industries in which the country does not have special advantages. Although in protected fields there are certain establishments which would be unable to compete without a tariff, these establishments are the high-cost producers. Economic forces tend to weed them out in favor of lower-cost producers. Tariffs, however, impede the natural workings of this principle of the survival of the fittest.

The rapid industrialization of the United States has been due to some extent to a high protective policy. The industrialization, however, would have come sooner or later, and without protection would have followed more natural lines. Without protection, industrialization might not have been carried so far, and this country would, therefore, have had less exodus from the rural communities to the cities and factory towns. The industrialization has both its benefits and its evils. Whatever valid arguments there may have been for protecting young industries in the early days of this country, these arguments no longer carry much weight.

One of the difficulties of fostering young industries by a tariff is that of determining what industries to favor. How is it possible to know which industries are suited to the country and

will be able to survive? The danger of fostering the wrong industries is great. This danger could be overcome to some extent by having low duties and temporary duties, but as a practical matter it is one thing to grant a duty "temporarily" and another thing to take it off. Industry resists vigorously the removal or reduction of a duty. Furthermore, if the government has encouraged capital to go into a particular field, has the government a right to leave an industry high and dry by removing the tariff when the tariff perhaps is really needed because the wrong industry has been encouraged?

Another difficulty with the infant industry argument is that if a country is naturally adapted to certain industries, those industries will probably develop there anyway, eventually. Furthermore, the losses involved in trying to discover such industries and hasten their development may more than offset any gains. There are, however, undoubtedly cases where facilitating the development of industry yields a net gain.

When all is said, the most important practical difficulty with a tariff to foster young industries is that it is easy to put on such a tariff but almost impossible to take it off. This is well illustrated by the experience of the United States. Industries will not permit the removal of duties, but instead clamor for, and have usually received more protection.

The protective policy in the United States has probably helped the development of some industries which have a legitimate reason for existing. Silk manufacturing got its start as a result of protection. A tariff was put on silk during the Civil War for revenue purposes, and the result was to bring into existence a domestic silk industry. Were the tariff on silk textiles now removed, a good portion of the industry could survive foreign competition, since certain kinds of silk fabrics can now be produced in the United States as cheaply as anywhere. The iron and steel industry also has been helped by protection. This industry, however, would undoubtedly have continued to develop, becoming as it has one of the major industries of the country, tariff or no tariff. It is impossible to determine to what extent protection has contributed toward the development of industries in America, or what the gains have been; but it

seems certain that in spite of the gains that there may have been, the net result is one of substantial loss. This is because of the commodities that tariffs have caused to be produced and sold in America at high costs, and because of the industries built up that have no economic place in America, and whose existence depends upon the continuance of protection.

**Tariffs May Diversify Production.**—Another argument for protection is that a nation's production may not be sufficiently diversified, as is the case in many parts of the world, notably in several of the Latin American countries. The prosperity of some of these countries rises and falls with the price of coffee, of sugar, or of some mineral. Where countries have their interests centered upon too few commodities, greater diversification of production and occupations fortifies the nation's economic position. It also places the life and social interests of the country upon a broader plane. A program of protective tariffs to bring about diversification is, however, not without its evils, namely, those just discussed. It should, therefore, be applied cautiously, since the evils may and in practice probably will more than offset the gains.

Industrialization has its own evils, especially if carried very far. England is probably overindustrialized and is too dependent upon foreign markets. A substantial part of her inter-war troubles were traceable to disturbances in her foreign markets. The tariffs and other restrictions which foreign nations imposed in their efforts to be self-sufficient were damaging to the English export industries; this damage was transmitted to other industries. The trouble in England was not so much what England did, as what the rest of the world did, politically as well as economically. If the rest of the world had followed the example of free-trade England, the world would have been better off. Great Britain therefore felt forced to restore some protection. To the extent that tariffs interfere with imports into Great Britain, the export trade is damaged. Although through protection, Great Britain might eventually become less dependent upon foreign markets, the volume of consumable goods would be less. The real solution for Great Britain, as well as for other

countries, lies in greater freedom in economic and trade relationships.

**Retaliatory Tariffs.**—Tariffs upon foreign goods are sometimes enacted for purposes of retaliation against tariffs and policies of other countries, and to place the country in a stronger bargaining position. The United States has been a prominent offender in inspiring retaliatory tariffs. A tariff against foreign goods is, of course, damaging to the foreign producers whose goods are shut out. If their country retaliates by a tariff against the goods of the first country, their country is in a better bargaining position and can grant and therefore receive concessions.

A retaliatory tariff, however, damages also the country enacting it, since it reduces still further the trade between the countries. In spite of the evils of a retaliatory tariff, such a course may be necessary. The enactment of tariffs against the United States seems to have had an effect on the United States, and was a factor in causing this country to reconsider its tariff policy. The tariff game, with whatever gains there may be in it, can be played both ways. If any gains are won they are won at the expense of some foreign nation, and the policy may prove to be a boomerang. Export industries in the United States are realizing how the American high tariff policy has been a factor in the increases in foreign tariffs against American goods.

**Emergency Tariffs.**—A temporary tariff may upon occasions be necessary to meet unusual situations. The rapid depreciation of a foreign currency may cause an inflow of that country's goods at such low prices as to disrupt domestic industry. Although the situation is only temporary, while it continues, which may be even for several years, it can be successfully combated only by restrictions against the goods of such a country with a depreciating currency.

Great Britain faced this situation after the first World War as regards German, French, and other European goods, and in 1921 enacted the Safeguarding of British Industries Act as protection. The United States faced the same situation in 1931,

1932, and 1933 when most gold-standard currencies broke down. The cost in America of a currency such as the Japanese yen fell more rapidly in the foreign-exchange market than commodity prices in Japan rose. The cost of Japanese goods, therefore, in terms of American dollars was low, and resulted in a strong outcry from American producers for protection against such depreciating currencies. The same situation existed in the case of the depreciation of the British pound.

Russian goods a few years ago were said to have been exported and sold abroad regardless of cost, for the purpose of getting a supply of foreign currencies. Such special situations as this one, and that of a depreciating currency, may make desirable some temporary restrictions on the importation of foreign goods, but have little bearing upon the arguments for a permanent policy of protection.

**Incidence of Tariffs.**—The first effect of a new tariff is for the cost of the goods to be higher to the importing house because it must pay the new duties to the government. An effort is thus made by importers to raise the price of the goods to the public. The importing house may try to raise the price by the full amount of the duty, but if this interferes too seriously with sales the importing house may sell on a closer margin of profit and pocket some of the loss occasioned by the new duty. At any event, if the tariff amounts to much, the foreign exporters of the article will doubtless find that their sales tend to be reduced, and may cut their selling prices somewhat, thereby bearing part of the tax themselves. These effects tend to be only temporary, since the importing house and the foreign producer will not be willing permanently to accept profits below the usual level. As the capital and efforts of importers and foreign producers are directed to more lucrative fields, the price of the commodity in question tends to rise, and the burden of the tax to fall upon the domestic consumer. Matters do not always work out smoothly according to this reasoning. Profits may already have been above the going level, or may for a long time continue below this level, the producers hesitating to change their businesses. Inertia prevents many tendencies from work-



ing rapidly, but sooner or later the domestic consumer must bear most of the burden of the duty. If he buys imported goods he pays a tax to the government. If he buys domestic goods he pays what amounts to a bounty to the domestic producer. A tariff is similar to a subsidy to certain producers, paid for not by the federal Treasury, but paid directly by the purchasers of the article.

Changes in the volume produced of certain kinds of imported goods may change the costs of producing those goods, entirely apart from price changes or price level changes. If a smaller volume is produced because of the tariff, this smaller production may mean a higher unit cost. Some of the economies of large-scale production may be lost, or for other reasons the producing costs may go up, in which case the industry would be said to be one of decreasing costs. The higher costs and reduced supply may cause the selling price of the foreign article to rise by an amount even greater than the tariff imposed. This would give still greater protection to the domestic producers, and cause a still higher price for the article to the consuming public. On the other hand, a smaller volume of foreign production may mean lower unit costs. This is the case when the industry is what is known as one of increasing costs. Under such conditions the price of the protected article would tend to go up by an amount less than the tariff.

**Types of Tariff Systems.**—Nations differ greatly in their tariff systems—both in the scope and height of tariff rates, and in the manner in which they apply tariff rates to similar products from different countries. Nations often grant certain other countries specially favored treatment. Broadly speaking, there are four divisions into which tariff systems or policies may be classified: (1) the simple policy of equal treatment to all like commodities, from whatever nation imported; (2) the policy of departing by treaty or convention from a *general* schedule of rates; (3) the policy of having two sets of rates, maximum rates and minimum rates, and of applying the minimum, or so-called most-favored-nation rates, to imports from countries entitled to them by treaty, and the higher column of rates to imports from

other countries; and (4) the policy of granting exclusive preferential treatment. We shall discuss these in order.

1. When a country offers equal treatment to all like commodities, regardless of the country of origin, it is said to have a *unilinear* or single-column tariff. The United States has for many years employed the single-column system, except with Cuba. Other countries adhering, prior to the outbreak of war, to some form of single tariff were Argentina, China, Japan, the Netherlands, Switzerland, and the Scandinavian countries. After the first World War, and particularly after 1929, there was a distinct trend away from unilinear tariff schedules. Less industrialized nations sometimes have had very simple tariff systems, in which a single low rate was levied on all imports, without regard to their nature. Tariffs of this type were primarily for revenue.

2. Another type of tariff system is the *general-conventional* tariff. This provides for a so-called *general* column of duties, usually established by statute. The general column applies to all countries except those with which tariff treaties or "conventions" have been made. The lower rates granted by these conventions constitute the *conventional* schedule or schedules. The principal advantage of such a system is its great flexibility in tariff bargaining. Australia, Chile, Czechoslovakia, Finland, New Zealand, and Turkey prior to the war had general-conventional tariff systems.

Certain nations, such as the Netherlands, Switzerland, and the Scandinavian countries, employed a form of general-conventional system which in actual practice was a single tariff. These countries granted conventional reductions to particular countries, but immediately extended these reductions, as a matter of policy, to all countries. Thus they granted equal tariff treatment, and to all intents had a single-column tariff.<sup>1</sup>

3. A number of countries have tariff systems which provide by statute for maximum and minimum rates for like commodities. In most instances of this kind, the minimum rates are

<sup>1</sup> United States Tariff Commission, *Extent of Equal Tariff Treatment in Foreign Countries*, Report No. 119, Second Series, 1937, p. 21. This booklet is a valuable compilation of leading facts concerning world tariff systems.

granted to countries with which trade treaties have been made entitling them to rates granted "most-favored" nations, the maximum rates applying to all other countries. The chief advantage of such an arrangement is that it encourages foreign nations to grant tariff favors, and at the same time permits the raising of the minimum rates by statute without violating treaty obligations. Increasing the minimum rates, however, is a sure means of incurring the resentment of the foreign treaty nations. Countries with maximum-minimum tariff arrangements included, in 1939, Brazil, Greece, France, and Poland. The most-favored-nation principle, embodied in many commercial treaties, and the use of maximum-minimum rates in connection with it, is discussed further in Chapter 28.

Canada has a three-rate tariff system, providing for minimum, conventional, and maximum schedules. The minimum rates are extended to the various parts of the British Empire, the conventional or intermediate rates to countries with which tariff treaties have been made, and the maximum rates to all other nations.<sup>2</sup>

4. No nation in recent times has pursued a policy of exclusive preferential treatment, a policy which, carried to its logical extreme, would involve making all tariffs on imports from every nation a matter of exclusive bargaining. France on two occasions has attempted a program pointing in this direction, but has been forced back to virtual uniformity in the application of its minimum schedule.<sup>3</sup> This is quite a different policy from that pursued by a number of countries which grant exclusive trade privileges to nations related to them by political, racial, or regional ties. Thus, member nations of the British Empire extend exclusive concessions to other member nations, and the United States grants certain favors of an exceptional nature to Cuba. Trade relationships of this kind are not customarily regarded as inconsistent with a single-tariff system.

**Tariff Terminology.**—Tariff duties that are assessed and collected on the basis of some physical unit, such as so many dollars

<sup>2</sup> Except former Austria, to which conventional rates were granted without treaty.

<sup>3</sup> *Op. cit.*, p. 5.

a bushel, ton, or yard, are called *specific* duties. Those, on the other hand, that are calculated on the basis of the value of the goods are said to be *ad valorem* duties. The value is considered by the United States and a few other countries to be that at the place of shipment of the goods, and is determined by the invoice of sale or by a customs appraiser.<sup>4</sup> In some cases, the duty collected is based upon a combination of the two methods; for example, 10 cents on each 100 pounds plus 15% of the value. This is commonly designated a *compound* duty.

When commodity prices are declining, specific duties, which remain the same in dollars and cents even though the goods sell for less, become relatively more burdensome to the payer of the duties, and also afford relatively more protection. Thus a duty of 10 cents on each 100 pounds is, from the percentage standpoint, less burdensome when the goods sell for \$1 per 100 pounds than if the price declined to 70 cents. Conversely, when prices are rising, specific duties become relatively lighter, and give less protection. *Ad valorem* duties, on the other hand, vary in amount with the value of the goods, and tend to yield about the same degree of protection at any given level of the commodity price average. When a particular foreign article, however, declines in price, the cheaper the article becomes, the less the protection to domestic competing goods by an *ad valorem* duty.

The term *drawback* refers to an amount of the duty which has been paid on imported goods, and which is refunded by the government if the goods are reexported. In the United States, no drawback is allowed unless the goods have been processed in the United States, e.g., if duty-paid sugar is used in canned fruit exported. *Compensatory duties* are those which are levied on imported goods for the purpose of raising their prices to protect domestic producers because of duties on raw materials entering into the manufacture of such goods. For example, a compensatory duty might be levied on imported shoes because of duties upon hides and leather.

When foreign countries aid certain of their producers by granting them bounties, other nations may impose *countervail-*

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<sup>4</sup> Most countries consider the value to be that of the goods landed within the country, or the cost plus insurance and freight (c.i.f.).

*ing duties* on the subsidized articles, in addition to duties previously in effect, to insure the degree of protection originally intended. Goods which are not subject to duties of any kind are said to be on the *free list*. Many countries have no free list but exempt certain items scattered through the schedules.

In the United States, tariffs are levied only upon the importation of goods. The exportation of goods, prior to the war, was entirely free and unrestricted. Trade between the different states is also free, as provided in the Constitution; this was not the case under the Articles of Confederation. To protect themselves against agricultural pests, states sometimes prohibit the entry of certain articles from other states. They have also in various ways devised restrictions upon the movement of goods across state lines. This, of course, is not a matter of tariff, but has much the same effect, and is for essentially similar purposes.

In 1937 the United States established in New York what is known as the Foreign Trade Zone, where goods can be received from foreign countries and reexported without the payment of duty to this country. Other such zones are being established in other parts of the United States.

**Measuring Tariff Protection.**—It is impossible to measure with any accuracy the effect of tariff changes, or to compare the protection afforded by one set of rates with that afforded by another. In the first place, there is no way of determining accurately the volume of imports excluded by a particular tariff duty. Imports of an article are constantly changing, and there is no way of knowing how much more would have been imported had there been no duty or were the duty lower. If a new duty were completely prohibitive, the effect could be roughly measured by the imports of the previous years. Furthermore, the same rate, for example, a 10% tariff on steel, would have different effects when levied in different countries. Such a tariff in a nation which had no steel industry would scarcely diminish imports of steel, and might be an excellent source of revenue. On the other hand, if levied in a country where most of the steel was produced domestically, the tariff might be completely prohibitive to foreign steel. In the latter event, it might make

no difference whether the tariff was 10% or 80%; the effect would be the same. Assume that the above steel-producing country had an 80% tariff on steel, and that, as a "concession," the tariff were reduced to 40%. The ineffectiveness of the move is obvious, although it would appear on the surface to be a downward revision.

A method commonly used in measuring tariff levels is to calculate the percentage which the amount of duties collected is of the total value of imports. This method, however, may be very misleading, since those rates which keep out foreign goods yield no revenue on the imports excluded. As a result, the percentage which customs revenues are of total imports is made *lower*, whereas to register the true state of affairs it should be *higher*. On the other hand, a protective duty may not exclude a large amount of imports for many years.

## CHAPTER 26

### PROTECTIONIST FALLACIES

**The Tariff Question a Political Issue.**—The tariff issue in the United States has unfortunately become intimately mixed with national politics. The agricultural south during the early years of this country's history had little need for tariff protection, while the manufacturing industries of the north discovered that tariffs were very useful. This geographical division with respect to interest in the tariff has to a large extent continued. The Republican party has thus sponsored protection, and the Democratic party free trade. The Democratic party, however, has gradually changed its position and has come to lean toward moderate protection. Since 1933, however, it has been actively seeking to reduce the extremely high tariffs it inherited, and has been undertaking this through the negotiation of reciprocal trade treaties.

Promises of protective duties have unfortunately proved to be good vote-getters. Business interests, anxious for tariff protection, have not found it difficult to persuade their senators, congressmen, or political powers that tariffs are necessary for the national welfare. It is argued that since these duties are of benefit to the individual industries, they are, therefore, indirectly beneficial to the nation as a whole. Seemingly plausible arguments are discovered in order to convince the public that this is the case. The fact that the benefit to the particular industry is usually at the expense of the rest of the country is not pointed out. Robbing Peter to pay Paul does not create new wealth, especially when Peter may need what has been taken more than does Paul, and also when what is taken from Peter is more than is given to Paul, the difference going to nobody but being lost to society. In the matter of tariffs, the public's in-

terest is not in harmony with that of the protected industry, but on the contrary is usually directly opposed to it.

**High Wages and Cheap Foreign Labor.**—One of the commonest and most plausible arguments for a tariff is that foreign goods must be kept out of the country so as to protect the American worker against cheap foreign labor. It is said that American producers cannot compete with foreign producers who pay low wages, and that without a tariff American wages will fall to the foreign level. In order to maintain the high American standard of living it is said, therefore, that a tariff is necessary. It is perfectly true that in some lines of industry the United States is unable to compete with foreigners, either because of low foreign wages or advantages of other kinds which foreigners possess. The United States cannot hope to excel in every line of undertaking. There are plenty of lines, however, in which America can successfully compete and undersell the foreigner in his own market. American goods produced by high wages are sent to all parts of the world, and offer the strongest kind of competition to the foreign producer. This indicates clearly that American costs for these goods are lower.

Real wages, as well as monetary wages, are high in America, not because of protection but because of the superior productive advantages and equipment in this country, the small population in relation to rich resources, and the skill and technical knowledge available here. Because of these factors the productivity of the American workman is high, and a high standard of living is the result. American capital and labor are effectively applied, and high wages therefore do not necessarily mean high costs.

If a particular industry in America cannot afford to pay the going rate of wages and at the same time compete with the foreigner, it is because other domestic industries are bidding higher for the services of the worker, since his productivity with them is high. These other industries have set a standard of productivity and pay which the weaker industry is not able to maintain. They attract the labor and capital. It is unfortunate for the weak producer, but if a producer is unable to produce as cheaply as someone else, he must sooner or later try his hand



in another field. The economic survival of the fittest, when everybody plays or is made to play according to fair rules of the game, gives the best results for everybody in the long run.

If an industry is unable to pay the high level of wages prevailing in America and to compete with other industries for workers, that industry should not be artificially supported, unless peculiar circumstances can be shown to justify special assistance. The existence of an artificially supported industry means that American labor and capital are being expended upon the production of articles which foreigners can produce more cheaply than can we. American labor and capital, therefore, should be allowed to go into other fields in which this country does have an advantage over the foreigner. Such favored fields exist in abundance in the United States. The fact that American goods, produced by the highest paid workers in the world, are able to go all over the world, bearing transportation costs, and to sell for less than goods produced by foreign, low-paid workers, is answer sufficient to the argument that a tariff is necessary to maintain high wages.

It is, of course, true that industries which depend upon a tariff in order to survive could not afford to pay high American wages were it not for the subsidy provided by the tariff, nor could they meet their other costs without the help of the tariff. In such uneconomic industries high wages may logically be said to depend upon protection. This is because if such industries are to obtain workmen they must pay the going rate of wages, which has been set at a high level by the more efficient industries. To do this they must sell their products at high prices which can be maintained only by tariff protection.

Although high wages in industries which are dependent upon protection could not be maintained without protection, the general high level of real wages in the United States is not dependent upon protection. In fact, the level of wages would be higher without protection, since workmen in the protected industries would then be more efficiently and productively employed elsewhere. They would eventually be absorbed by other industries, perhaps by export industries, demand for the goods of which would be stimulated by the increased imports following

the removal of the tariff. Wages were high in America before the day of high protective duties and cannot be said to depend upon them.

**A Competitive Tariff to Equalize Costs of Production.—**

Both of the major political parties in the United States have at various times declared that they favored a tariff sufficiently high to equalize the high costs here with the low costs abroad. Such a tariff is sometimes referred to as a "competitive tariff." The aim would be to have duties equal to the difference between the high costs here and the low costs abroad.<sup>1</sup>

Two difficulties are involved in this idea. In the first place, monetary costs in any industry show a great deal of variation. Some producers have low costs and large profits, while others have high costs and may even be operating at a loss. The question is, whose costs are referred to, both here and abroad, when it is said that duties should be equal to the difference between domestic costs and foreign costs? Furthermore, the difficulties of determining the costs of any particular establishment are great, especially of an establishment abroad. Attempts to determine them have sometimes caused ill-will.

The second difficulty with the argument is that trade takes place only because monetary costs, in terms of exchange rates, are different in the trading countries. Unless the foreigners' costs, and therefore selling prices, are lower, he is unable to send over his goods for sale. If a duty were really successful in equalizing costs, it would shut out completely the foreigners' goods. A tariff to equalize costs, therefore, means a tariff to prohibit completely all foreign goods to which it is applied. If foreign goods continue to come in over the tariff, this fact is an indication that the tariff does not equalize costs for everybody. It means that some foreign producers still have lower costs, after adding the duties, than some of the domestic pro-

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<sup>1</sup> This is the philosophy which has been behind much of the work of the United States Tariff Commission, acting under instructions from Congress. The Commission endeavored to discover costs of production here, and costs of production abroad as a basis for adjusting the rates of duty. More recently the Commission's studies have been for the purpose of determining which duties can be reduced with the least disturbance to American industries. The Commission is endeavoring to assist the State Department and other agencies in an effort to free trade from some of its barriers.

ducers, unless, of course, the foreign goods are different in quality and design, or bring more prestige to the purchaser. If this principle of equalizing costs were strictly applied, it would lead to the complete exclusion of the commodities against which the duties were assessed. If the principle were applied to all commodities, and there is no logical reason why it should be applied to one and denied to another, it would cause a cessation of all imports, which in turn would result in a cessation of all exports, except such as might be to pay for invisible imports.

**Preserving the Home Market for the Home Producer.—**

Another popular argument for a tariff is that by keeping out foreign goods a tariff saves the domestic market for the home producer. This is sometimes referred to as the "additional market" argument. It is supposed that a tariff creates an additional market, namely, a greater home market. The slogans "Buy home products," "Buy British," or "Buy American" are based upon this same false notion.

Persons who advance this argument fail to understand the give and take nature of foreign trade, or of any trade, that exports pay for imports, and vice versa. The foreign transactions of a country must balance, as discussed in Chapter 7, and if imports are cut off, exports will correspondingly be cut off. If the foreigner is unable to sell to us, or to some other foreigner, he is unable to get the wherewithal to buy from us. A particular domestic producer may get an additional home market because of a tariff, but he acquires this market at the expense of another producer, who, as a result of the tariff, loses part of his foreign market. The public, moreover, is required to pay a higher price for the protected article produced under less advantageous conditions and at higher costs than the foreign article.

The foreign market which is lost by the imposition of a tariff is just as good as the domestic market gained. At the same time, the domestic industry which is expanded, and which enjoys a greater home market, is less suited to the country than the industry forced to reduce its foreign market. Labor and capital are withdrawn from the efficient industry and directed into the inefficient industry. A tariff, in effect, forces two citi-

zens to trade with each other instead of with foreigners. If it were to their advantage to trade with each other they would have discovered this fact without a tariff. It is because cheaper, better, or different goods can be obtained abroad that foreign trade takes place. Purchasing goods from a foreigner when it is to a person's interest to do so is the logical procedure, and means that the person so doing is better off than if he were forced to patronize home producers. The foreigner, who has received dollars by selling, is at the same time enabled to buy goods from our country, so that we do not lose any business. We also get the desired goods more cheaply.

The tariff question has been explained clearly by Professor Taussig as follows:

The free trader argues that if the duties were given up and the protected industries pushed out of the field by foreign competitors, the workmen engaged in them would find no less well-paid employment elsewhere. Presumably they would betake themselves to the exporting industries, in which labor is advantageously applied. The protectionist answers that there would then be "overproduction" in those industries,—that more goods would be produced, prices would be lower, and then wages lower. No, replies the free trader,—there would be more goods, but not lower prices or lower wages. For there is a new demand for those exportable goods, *pari passu* with the new supply. Goods are imported which were formerly made by protected industries. The new imports must be paid for by exports; there is a new foreign "market" replacing the lost domestic "market." The eventual result, says the free trader, is that more workmen will be turned to the advantageous industries, and more goods will be exported in exchange for more imports; there will be higher wages (in terms of commodities) all around within the country, resulting from the more productive direction of its labor.

In all this reasoning, the free trader is right.<sup>2</sup>

**Keeping Money at Home.**—A phase of the argument of saving the home market for the home producer, and involving the same fallacy, is the idea of "keeping money at home." It is presumed that, by spending at home, the money stays at home, and "home" is thereby wealthier. This was part of the philoso-

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<sup>2</sup> F. W. Taussig, *Principles of Economics*, Vol. I, Ch. 36.

phy of the mercantilists and involves a confusion of wealth and money.

Money is merely a means to an end, a measuring stick for values. More money means more counters for the existing wealth, and is not itself the wealth which it represents. Money represents a claim to a certain amount of real wealth, and if we spend money abroad we are giving the foreigner a claim to some of our wealth in exchange for some of his. In a strict sense the currency of any country cannot be spent anywhere but at home, since it is ordinarily not current in foreign countries. When we buy abroad we in effect give the foreigner our money in exchange for his. We then spend his money over there and he spends ours over here. The transaction is really an exchange of goods for goods. If we spend the money locally we are giving a local person a claim on whatever wealth he wishes to buy, in exchange for some of his wealth.

This question is the same as that above, namely, whether we should trade with domestic producers or foreign producers. If trading with the domestic producer costs us a higher price, poorer goods, or means a sacrifice of some kind, this is pretty clear indication that he is an inefficient producer, and that he should not be maintained at the expense of the efficient. As applied to a particular locality or neighborhood, there are often mitigating circumstances. A person may trade at a neighborhood store even at some sacrifice, since he wishes to have the store continue there as a matter of convenience. Local pride and the desire to see his town flourish—which may perhaps react to his personal interest—may cause a person to buy locally even at a sacrifice.

**Tariffs and the Demand for Labor.**—It is sometimes argued that tariffs increase the demand for labor. Workmen are told that if foreign goods are kept out of the country there is that much more work for the American worker. He is needed then, the argument runs, in making goods that were formerly imported. On the surface this seems plausible enough, and yet the fallacy is not far to seek. If imports are shut out, exports are also shut off and there is less work in the export industries.

Furthermore, the employment of labor is not an end in itself, but merely a means to the production of wealth. The work is performed for the sake of the things produced. If workers are employed in the most productive ways, the worker and everybody else have more commodities to consume. The welfare and real income of a worker depend largely upon how much wealth he is able to produce, rather than upon how many hours he puts in during a given time.

Moreover, there are not just so many jobs to be parceled around, but an infinite amount of work to be done. Unemployment comes and goes in varying degrees. Some unemployment unfortunately exists all the time, because of changes in industry, in consumers' demands, in the business cycle, and because of the slowness and difficulties of economic adjustments of various kinds. Unemployment has many causes, which, however, do not include the freedom to trade wherever a person can find the best bargain. Tariffs do not prevent or even reduce unemployment. Removing a tariff, however, might cause the now unprotected industry to restrict operations, and involve unemployment for its workers. This would not be permanent but would continue until adjustments to the new situation were accomplished and the workers had found jobs elsewhere. The speed with which these workers could be absorbed into other industries would depend upon such things as the degree of prosperity of the country, the extent to which the workers' abilities were specialized, and the aggressiveness of the workers themselves in locating new work.

Unemployment rises and falls accompanying business fluctuations, being less in periods of prosperity and greater in periods of depression. This, however, is a matter distinct from that of protective tariffs, and it cannot be said that unemployment is prevented or relieved by a tariff. In fact, the levying of a tariff necessitates readjustments in industry which tend to cause unemployment in the export industries. If we shut off the importation of goods we will eventually shut off the exportation of our own goods to an equivalent value, and thereby throw men out of work.

A temporary situation, such as the influx of foreign goods because of foreign currency and exchange disorders, may properly be dealt with by a tariff as already discussed. A tariff to meet such an emergency might restore employment to workers in the affected industry. The danger of such a tariff is that it is usually difficult to remove it when the emergency has passed.

**Reducing Tariffs.**—In spite of the many advantages of free trade over protection, once a tariff is in force and production adjusted to it, the removal of the tariff involves a great many difficulties. A man who climbed up to the top of a tree may be in a precarious position and perhaps had no business in getting up there, but there he is, and the problem of how to get down may not be easy. He cannot suddenly let go. If tariffs were abruptly swept aside some of our industries might be plunged into bankruptcy, involving unemployment and loss to many persons. The opinion of economists close to this country's tariff situation is that this would probably not be the case as regards any significant part of our major industries. They believe that the shock of adjusting to a free-trade basis has been overestimated. On the other hand, the government by its tariff policy has for a long period of years encouraged capital to go into certain fields. The government, therefore, could be charged with bad faith if it were suddenly to remove the tariff and leave these fields unprotected.

Reduction of the tariff is nevertheless highly desirable, and should be accomplished in spite of the difficulties involved. If the tariff is removed gradually the evils are much less, and in many cases almost non-existent. The speed with which the different rates can be lowered without disturbance depends in part upon the permanency of the capital invested and its rate of depreciation. If a protected industry happens to be one possessing a large amount of fixed capital which cannot easily be utilized for any other purpose, the removal of the tariff means the waste of equipment which cannot be converted to other purposes. If, however, the capital depreciates rapidly, and if the rates of duty are lowered gradually, there is little or no loss. If the capital is of a kind which can readily be converted to other

purposes, if it consists, for example, of a standard type building and simple machinery, the gradual reduction of the tariff involves little loss, social or individual. Such loss as may be suffered is a deduction from the permanent gains of free trade.

Sentiment in favor of tariff reduction has been increasing, and the United States Government, under the leadership of Secretary of State Hull, has been negotiating reciprocal trade treaties with foreign nations to reduce tariffs by joint action. It has accomplished a good deal in this direction as noted below. The war interrupted this program and altered the entire situation. During the war, however, trade agreements have been made with some of the Latin American countries.

Some of the high rates can be reduced fairly rapidly, while others require more time for adjustments. Some industries can prosper without any protection, so that the rates could be removed almost immediately without involving serious trouble. From the economic standpoint the speed with which reductions take place would have to take into consideration not only social losses and gains but also the matter of individual losses and the injustices which might be done. An individual who has built up a business on the basis of protection cannot be suddenly left unprotected. He must be dealt with fairly, and be given time and opportunity to readjust himself.

In the United States, industry is continually changing, new processes are invented and old ones discarded, new equipment is installed and old equipment junked. Labor is continually moving from one job to the next. The war has caused a tremendous upheaval in industry. In such a dynamic society a reduction of most of the tariff rates, perhaps spread over a few years, would not entail much loss to many individuals.

Farmers sell most of their produce in a free market, but buy their manufactured articles in a protected market. The farmers, however, have been taught that a tariff is helpful to them, since it is said to maintain high wages and permit workers to consume more farm products. Many of the farmers have become skeptical, and have also demanded tariffs upon farm products. A tariff upon the importation of products which a country in fact exports, can have slight effect one way or the other. Much



of our agricultural produce is of this kind. Its price is fixed in the world market, and since the product is exported rather than imported, a duty can have little or no effect.

The public, which would benefit by a reduction of duties, is unorganized, does not understand the economics of tariffs and protection, nor do most people individually have very much at stake. Progress, however, is being made in that economic knowledge on tariff matters is becoming more widely disseminated, and some of the export industries and other interests damaged by tariffs are aware of their losses. Foreign retaliation against America has also been partly responsible for changing sentiment. The part tariffs and other nationalistic restrictions played in bringing on the war is one of the strongest indictments of such policies, and reasons for their elimination.

**Tariffs Imposed by a Creditor Nation.**—A high tariff policy by a country which is a creditor nation, such as is the United States, makes the payment of interest and dividends upon its foreign loans difficult for foreign debtors. The interest must be paid in goods or services, and yet the United States has said in effect that it does not care to receive goods and has made difficult the sending of them. The tariff policy of the United States was a factor in the large gold shipments to the United States in the inter-war period. It also was a factor in the breaking down of the currency systems, in 1931 and the years following, of nations which were subjected to a drain on their gold, because foreign nations would not accept their goods.

The United States, as a result of the first World War, became an important creditor nation, necessitating radical readjustments in its foreign trade, particularly an expansion in imports. Yet the United States did not wish to accept foreign goods, and raised barriers to keep them out. As long as the United States was loaning heavily abroad, the new loans relieved the situation by keeping exports going and postponing settlement of funds due this country. The interest due the United States was in reality accumulating abroad and being re-invested there. When a cessation of lending took place, foreign

nations found the transfer of the money which they owed practically impossible.

One of the greatest evils of a tariff is the corruption and near corruption that accompanies a system of giving favors to certain industries. A contribution to the political party chest may be the price for a tariff duty. Lobbyists or "legislative advisers" who guide a bill on its way are less brazen in their methods and less corrupt than formerly, yet their influence, subtly exerted, is far-reaching. Their activities, of course, extend beyond tariff legislation, but tariff duties are commonly the result of lobbying.

Tariffs are ostensibly passed for the general welfare, yet the campaign for their passage is financed by interested industries. Through log-rolling and a swapping of votes, duties have been piled higher and higher. Congressman A agrees to vote for a duty to please Congressman B in exchange for B's agreement to do the same for A. Well-meaning congressmen have often been practically forced to play the game or they would not have been returned to office. The tariff question is not a new one, nor are there indications that it will cease to be an active one.

## CHAPTER 27

### TARIFF POLICIES OF THE UNITED STATES

**American Tariff History from the Revolution to Jackson.**  
—American tariff history has been characterized by a tendency toward constantly increased protection. Since near the beginning of the last century, this country has pursued a definitely restrictive trade policy. Republican administrations have commonly raised tariffs, while Democratic administrations have usually reduced them, but not to the former levels. Since the passage of this country's first tariff act in 1789, there has been a new tariff on an average of every seven years. Most of the changes in American tariff policy have been brought about largely by temporary partisan majorities and by political pressure from benefited interests. The welfare of the nation as a whole has usually been a distinctly secondary consideration. The effect upon foreign nations has, until very recently, received no consideration.

After American independence had been achieved, the regulation of commercial relations became the prerogative of the individual colonies. Partly because of antipathy for the colonial policy of Great Britain, which involved extensive trade restrictions, sentiment in favor of freedom of trade was sufficiently strong during the period of the Confederation to insure the prohibition in the Constitution of interstate trade barriers.

The first Act of Congress under the Constitution levied a tariff, which was primarily for revenue. Most of the separate rates, as well as the general average rate, were the lowest ever established by Congress. There was no free list, a 5% rate being imposed on all goods not otherwise provided for.

Interest in protection as a national policy developed rather early in American history. There was a feeling that the source of British wealth and power lay in her efficient manufacturers.

In 1790, Alexander Hamilton, the young Secretary of the Treasury, was instructed to prepare a report on the protective tariff in relation to the development of domestic manufacturing. In 1791 he submitted to the House of Representatives a report on manufactures in which he carefully considered the case for and against protection in America. He came to the conclusion that a tariff would facilitate the growth of industries which in turn would promote national unity. He therefore advocated a policy of moderate protection, which he thought, also, would aid in developing a more stable and balanced economy. In addition to advancing the infant-industry argument, and that of military self-sufficiency, the Secretary urged expansion of the domestic market for American agriculture. Hamilton believed that so long as the United States confined its production largely to agricultural products and raw materials, which were to a large extent sold abroad, its prosperity would depend upon the uncertain whims of foreign markets. He therefore advocated the encouragement, through mild protection, of domestic manufacturing. Expansion of domestic industry, he thought, would provide a dependable internal demand for farm produce.

Hamilton also suggested bounties as a means of aiding industry, and in fact preferred them to tariffs. Bounties, he argued, were more direct; they do not raise prices or produce scarcity. They also promote exports, which is not true of protective tariffs.

From the signing of the Constitution in 1789 until 1812, thirteen tariff laws were passed, chiefly for revenue purposes. Many of the rates were gradually increased during this period to obtain larger revenues. Some articles, however, were placed on the free list.

The War of 1812 virtually put an end, temporarily, to the previously thriving foreign commerce, trade having fallen in 1814 to less than one-twelfth its former maximum. Tariff rates were therefore doubled in the hope of securing more revenue, but without avail.

When peace returned, imports were resumed on a large scale, and the demand for protection against this competition became great, since the absence of foreign products during the war had

stimulated the growth of domestic manufactures. Accordingly, the Tariff Act of 1816 was adopted, and included definitely protective features, rates being sharply raised on many articles. Judged by later standards, however, this tariff was very mild; it largely failed, in fact, to protect industry. Consequently, the Tariff Act of 1824 provided for further increases.

**American Tariff History from Jackson to Lincoln.**—The notorious Tariff Act of 1828, remembered as the "Tariff of Abominations," was a poorly framed protectionist measure which provided for rate increases on all goods, some rates as high as 100% ad valorem. The tariff was bitterly resented in the south, and leading southern statesmen urged its nullification. The issue contributed to the ill feeling which culminated in the Civil War.

The Tariff of 1832, during the administration of Andrew Jackson, represented a mild downward revision and was an attempt to placate southern resentment, but the south was by no means satisfied. Since both north and south wished at this time to avoid actual conflict over the nullification issue, the so-called Compromise Tariff of 1833 was passed, providing for a process of reduction during a period ending in 1842. According to this plan, the reduction in rates was to be small at first, gradually increasing so as finally to bring the maximum rate on any article down to 20%. The 20% rate remained in effect only two months in 1842, however, being replaced by a distinctly protective Whig tariff which remained in force for four years.

The incoming Democrats in 1846 passed what is commonly referred to as the "Walker Tariff." Although by no means free from protective elements, this act established generally lower rates and a less complex tariff system. The Walker Tariff remained in effect for eleven years, during which time the country enjoyed great economic advancement. In 1857, rates were again generally reduced, with a provision that the maximum duty was to be 24%. This reduction took place at the peak of a boom, just prior to the collapse in the summer of that year.

**American Tariff History from Lincoln to McKinley.**—The Civil War saw a sharp reversal of American tariff policy and

a renewal of the clamor for protection. Under the Republican Morrill Act of 1861, which went into effect just before Fort Sumter was fired upon, rates were sharply increased, for admittedly protective reasons. Until the close of the war in 1865, some rates were increased almost every month, with virtually no debate. Rates were raised far above any levels previously attained. The two most important tariff acts of the war were those of 1862 and 1864, the latter raising rates to an average of 47% on a long list of items. In addition to the extensive tariff increases, internal revenue taxes were imposed on many kinds of manufactures. These were all regarded at the time as distinctly emergency measures.

Like the War of 1812, the Civil War had greatly stimulated manufacturing in the north. Consequently, when the war was over there was a strong demand for continued protection. Inasmuch as the south had lost heavily in political prestige, it is not surprising that the high war-time tariffs were left almost completely alone. The actual protection, in fact, was increased by the rapid repeal of the heavy internal excises. Furthermore, the tariff on woolen goods was increased in 1867, to be followed in 1870 by many other increases of a protective nature.

With recovery from the panic of 1873 and the subsequent depression, a growing popular demand for downward revision became evident. The tariff was a leading issue in the campaigns of 1876 and 1880. In response to public sentiment for reduction, the Republican tariff of 1883 was passed, which, however, was little more than a gesture made by the friends of protection. Some rates were lowered, while others were raised with a definitely protective purpose.

Although Harrison was elected by a narrow margin in 1888, the Republicans accepted the victory as a mandate for further protection, and proceeded to enact the McKinley Tariff of 1890. It is interesting to note that in the speeches in favor of this act, the infant-industry argument was abandoned, it being obviously irrelevant, and instead the "pauper-labor" argument<sup>1</sup> was substituted. The new law extended protective rates to agricultural

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<sup>1</sup> See page 458.

products; rates on wool were increased and a bounty was granted to sugar producers, the duty on imported sugar being removed.

The Democratic Party under Cleveland returned to office in 1893, and the following year the Wilson Tariff Act was passed. While nearly all changes by this law were in a downward direction, the reforms as a whole were not great, and the measure was distinctly disappointing to many Democrats. President Cleveland, in fact, allowed the measure to become law without his signature. Most notable among the downward changes of this act was the placing of raw wool on the free list.

The Republicans celebrated their 1896 victory in the enactment of the Dingley Tariff (1897), which provided for a steep increase in protective rates. The duty on wool was again revived, and high rates were levied on silks, linens, woolens, and other articles. The Dingley Tariff remained in effect for twelve years, the longest for any tariff law in American history until the Hawley-Smoot Tariff of 1930. Because of a steady rise in the commodity price level, the average rates under this act tended gradually to become more moderate, specific rates becoming relatively smaller percentages of value.<sup>2</sup>

**American Tariff History Since 1900.**—The Republican Payne-Aldrich Tariff of 1909, like the Tariff of 1883, was the response to a demand for downward revision. Like the earlier act it was a revision by the friends of protection. Many changes in rates were made, both downward and upward. Experience under the act provided that little reduction, if any, had been accomplished. A special feature of the law was the establishment of minimum rates, with provision for possible imposition of maximum rates, which were to be applied by the President. Provision was made for countervailing duties on foreign articles which had been produced with the aid of government bounties. This provision was in the Dingley Tariff of 1897, and was brought forward without change. The Payne-Aldrich Act was the object of extremely bitter criticism, and became a leading issue in the campaign of 1912.

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<sup>2</sup> See page 454.

When the Democrats returned to power under Woodrow Wilson, a reversal of tariff policy was inevitable. The Underwood Tariff Act of 1913 was the result. Among its principal features were: (1) a general and marked reduction of rates, (2) the substitution of ad valorem for specific rates in many instances, (3) considerable additions to the free list, especially of raw materials, and (4) the taxation of luxuries and special articles more highly than necessities and plain types of goods. Unfortunately, the law had been in operation only nine months when the World War broke out in the summer of 1914. The act was thus never given a real test, although it remained in effect for eight years. The war, by interfering with European industry, gave American manufacturing interests far greater protection than had the much maligned Payne-Aldrich Tariff.

With the return to office of the Republicans after the war, and with the revival of European competition stimulated by depreciated currencies, an Emergency Tariff Act was passed in 1921 providing increased protection primarily to agriculture. The Fordney-McCumber Act of 1922 extended this program, including the protection to agriculture, which had been badly injured by the collapse in war-time prices, and provided very substantial protection to industry. The rates, on the whole, were higher than any which had been levied for many years, being above those of the McKinley Act of 1890, the Dingley Act of 1897, and the Payne-Aldrich Act of 1909.

The Fordney-McCumber measure was superseded in 1930 by the Hawley-Smoot Tariff, often referred to as the highest in American history. Advances in rates were clearly intended to be prohibitive in many instances. The number of dutiable items was raised from 2,840 in the Act of 1922 to 3,221 in the Hawley-Smoot measure.

The decline in commodity prices between 1929 and 1932 served to make all specific duties more protective than they otherwise would have been. In some cases the resultant increase in the real protection was great. The United States Tariff Commission listed 540 articles on which the duty in 1931 exceeded 50% of the value. On silk hosiery the duty was 60% ad valorem, on wool fabrics it was equivalent to 84%, on clocks



109%, and on onions 148%. In several cases, the duty became more than 200%.

When the Democrats returned to power after the election of 1932, they were pledged to reform the tariff situation. The Democratic platform of that year claimed that the Hawley-Smoot tariff had been the occasion for retaliatory action on the part of 40 nations. In June, 1934, the so-called Trade Agreements Act was passed as an amendment to the Tariff Act of 1930. The program which resulted from the enactment of this law is discussed later in this chapter.

In spite of tariff reductions under the Trade Agreements Act, increased protection was afforded by means of import excise taxes, first introduced in 1932. These taxes are identical with tariffs except in name and in one respect, namely, they cannot be changed under the flexible provisions of the Trade Agreements Act. The increase of these taxes as a substitute for tariffs gave protection to several important articles such as copper, petroleum, coal, lumber, oils, and fats. With one exception these excise taxes were not allowed to expire when the period for which they were originally imposed ended.<sup>3</sup>

**The United States Tariff Commission.**—The United States Tariff Commission was created in 1916 during Woodrow Wilson's administration, with the hope that it would help to take the tariff out of politics. It was intended to put tariff-making on a scientific basis, as opposed to the method of log-rolling and political pressure. The commission was set up as an independent, fact-finding body, authorized to study the entire problem of the tariff and to make reports.

The commission, altered somewhat in 1930, consists of a bipartisan body of six members—three Democrats and three Republicans—appointed by the President and approved by the Senate. Each commissioner is appointed for a term of six years, receiving a salary of \$11,000 per year. The commission employs a large staff of experts and investigators. In carrying out its duties, it is permitted to examine the files of any business con-

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<sup>3</sup> C. R. Whittlesey, "Excise Taxes as a Substitute for Tariffs," *American Economic Review*, December, 1937.

cern and to order witnesses from any part of the country to appear, testify, or submit documentary evidence.

The commission in its first years gave special study to foreign tariffs and foreign tariff policies. Some of the material developed by the commission was used in congressional debates, but usually only when it supported desired ends. The commission did not succeed in taking the tariff out of politics, although something in this direction was accomplished in connection with the Trade Agreements program.

One of the important duties of the Tariff Commission was in connection with the "flexible" provisions of the Tariff Acts of 1922 and 1930. These provisions gave the President power to raise or lower tariff rates, by not more than 50%, whenever the commission determined that duties on a particular article did not equalize foreign and domestic costs of production.<sup>4</sup> The provisions authorized the commission to make studies of production costs at home and abroad when it felt that complaints regarding existing tariff rates were justified and, on the basis of such studies, to make recommendations to the President. Accordingly, the commission made extensive cost-of-production studies in various parts of the world.

Many of the cost studies under flexible provisions were of little practical value. In the first place, as pointed out in the chapter on protection fallacies, the cost-equalization principle is fallacious. The very reason for trade is a difference in costs, and if costs were equalized this would remove virtually all occasion for foreign trade. A further difficulty is in the fact that costs vary widely within the same country, with the result that the problem arises of whose costs are to be taken as a basis. Furthermore, foreign nations did not take kindly to the idea of American Tariff Commission investigators studying their costs and other data.

Prior to the world depression, the flexible provisions were used principally to raise duties and but rarely to lower them. From the time of the enactment of the Fordney-McCumber Tariff in 1922 to the year 1929, the President proclaimed 37

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<sup>4</sup> Duties might be raised by more than 50% if this was the result of the change from foreign valuation to American valuation.

tariff changes. In only five of these were duties lowered, all the others being increases.<sup>5</sup>

Since the enactment of the Trade Agreements Act in June, 1934, activities of the commission under the flexible provisions have been greatly curtailed. Changes in rates which might otherwise have been made under the flexible provisions have instead been effected by the reciprocal agreements. Thus in 1936 only five investigations, looking toward changes in rates, were instituted by the commission under the flexible provisions, whereas, in the first year of the Tariff Act of 1930, 39 investigations were instituted, completed, and reported to the President. Moreover, the law of 1934 provides that when changes in tariff rates have been made under the flexible provisions (or when rates are "bound," i.e., the United States has promised to make no increase) the rates shall not be subject to further change under these provisions.

Since 1934, the Tariff Commission's activities have been quite different from those of earlier years. It increased its staff of trained economists, who understand the economic aspects of foreign trade and of trade barriers. Comprehensive and scientific studies have been made by the commission on many important subjects. The commission has given particularly valuable service in connection with the reciprocal trade agreements discussed below.<sup>6</sup> During the war it devoted much of its time to investigations for the Board of Economic Warfare and other governmental agencies.

**The Trade Agreements Program.**—As a part of the New Deal Program, Congress, in June, 1934, passed what is often called the Trade Agreements Act—an amendment to the Tariff Act of 1930. The purpose of this new law was to make possible a program of tariff reduction in return for trade concessions by foreign nations; the agreements negotiated are thus called "reciprocal trade agreements." The measure grants the President power to make agreements with foreign nations involving

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<sup>5</sup> United States Tariff Commission, *Annual Report 1929*, pp. 23-25.

<sup>6</sup> A history of the Tariff Commission's activities during the first twenty years of its existence, 1916-1936, is contained in the *Annual Report of the Commission for 1936*, pp. 2-8.

alterations in the tariff, without referring the agreements to Congress for approval. This eliminates much of the red tape previously involved in tariff changes, and also the two-thirds vote of the Senate required in approving treaties.

The President's authority under the act is subject to the following limitations: (1) he may not lower or raise duties by more than 50%; (2) he may not transfer an article from the free list to the dutiable list, or vice versa; (3) before concluding a reciprocal agreement he must give notice of such intention, in order that all interested parties may have an opportunity to express their views; and (4) he must seek the information and advice of the United States Tariff Commission and the Departments of Agriculture, Commerce, and State. While the President is prohibited from removing any article from the free list, he is authorized to promise a foreign power that an article which is on the free list shall remain there, or to guarantee that an article which is dutiable at a given rate shall continue dutiable at not exceeding that rate. The President may modify without limitation any import restriction which is not a customs duty.

Up to July, 1942, the United States had signed trade agreements with 23 foreign countries, as shown in Table 16. These agreements included reductions in duties by the United States upon hundreds of foreign goods, as well as promises not to remove certain articles from the free list nor to increase certain duties. Concessions made by other countries upon American exports to them were fully as extensive.

With two exceptions the trade agreements program is based on the principle of equality of treatment, whereby any trade concessions granted by this country to any particular nation are automatically extended to all countries whether or not the United States has most-favored-nation treaties with them. The two exceptions are: (1) with Cuba, with which this country has long had a preferential arrangement, and (2) with nations which discriminate substantially against products of the United States.

Negotiation of the trade treaties has been undertaken enthusiastically by the Department of State, under the leadership of Secretary Cordell Hull, and with the active cooperation of the Tariff Commission and interested departments. This coun-

try has thus reversed its position, and has actively sought to reduce trade barriers and revive world commerce. In order not to disturb American industry and to keep opposition at a minimum, this country has sought, as far as possible, to grant tariff reductions on goods of which only a small proportion are produced domestically, and on goods the importations of which have been relatively small. The trade agreements program has had to contend with opposition from certain American businesses. Watch manufacturers, for example, objected to the agreement with Switzerland, and lumber interests were hostile to the agreement with Canada which permitted Canadian lumber, along with several other commodities, to come in under new and cheaper rates.

The trade agreements program contributed materially to the increase of this country's foreign trade. This is revealed by an analysis of trade, prior to the war, with agreement and non-agreement countries. During the two years 1938-1939 United States exports to countries covered by the 16 agreements in force during this entire period averaged about 63% greater than in 1934-1935, when only one agreement was in force, while United States exports to all other countries increased by only about 32%. On the import side, imports from the 16 agreement countries in 1938-1939 averaged about 22% greater than in 1934-1935, whereas imports from other countries averaged only about 11% greater. During the two-year period of 1937-1938 the situation with reference to agreement and non-agreement countries was somewhat similar to that of the later years.

According to the Trade Agreements Act, the powers given the President were for a period of three years. These were renewed in June, 1937, and again in June, 1940, for another three years, but in the latter case the act was not renewed without a considerable struggle.

One of the early and important trade agreements was that made with Canada, which went into effect January 1, 1936, revised in 1938 and supplemented in 1939 and 1940. According to this agreement American products received many specific concessions from Canada, as well as unconditional "most-

TABLE 16. TRADE AGREEMENTS SIGNED BY THE UNITED STATES

Country	Date Signed	Date Effective
Cuba .....	Aug. 24, 1934	Sept. 3, 1934
Belgium .....	Feb. 27, 1935	May 1, 1935
Haiti .....	Mar. 28, 1935	June 3, 1935
Sweden .....	May 25, 1935	Aug. 5, 1935
Brazil .....	Feb. 2, 1935	Jan. 1, 1936
Canada (see revised agreement below)....	Nov. 15, 1935	Do.
Kingdom of the Netherlands (Netherlands in Europe, Netherlands India, Surinam, and Curaçao) .....	Dec. 20, 1935	Feb. 1, 1936
Switzerland .....	Jan. 9, 1936	Feb. 15, 1936
Honduras .....	Dec. 18, 1935	Mar. 2, 1936
Colombia .....	Sept. 13, 1935	May 20, 1936
Guatemala .....	Apr. 24, 1936	June 15, 1936
France and its colonies, dependencies, and protectorates other than Morocco.....	May 6, 1936	Do.
Nicaragua <sup>a</sup> .....	Mar. 11, 1936	Oct. 1, 1936
Finland .....	May 18, 1936	Nov. 2, 1936
El Salvador .....	Feb. 19, 1937	May 31, 1937
Costa Rica .....	Nov. 28, 1936	Aug. 2, 1937
Czecho-Slovakia <sup>b</sup> .....	Mar. 7, 1938	Apr. 16, 1938
Ecuador .....	Aug. 6, 1938	Oct. 23, 1938
United Kingdom, including Newfoundland and the British Colonial Empire.....	Nov. 17, 1938	Jan. 1, 1939
Canada (revision of agreement of 1935)...	Do.	Do.
Turkey .....	Apr. 1, 1939	May 5, 1939
Venezuela .....	Nov. 6, 1939	Dec. 16, 1939
Cuba (supplementary agreement).....	Dec. 18, 1939	Dec. 23, 1939
Canada (supplementary agreement).....	Dec. 30, 1939	Jan. 1, 1940
Canada (supplementary agreement).....	Dec. 13, 1940	Dec. 20, 1940
Argentina .....	Oct. 14, 1941	Nov. 15, 1941
Cuba (supplementary agreement).....	Dec. 23, 1941	Jan. 5, 1942
Peru .....	May 7, 1942	July 29, 1942
Uruguay .....	July 21, 1942	( <sup>c</sup> )

Countries with which intention to negotiate has been announced: Iceland, Bolivia, Mexico, Iran.

<sup>a</sup> Certain provisions of the trade agreement ceased to be in force as of Mar. 10, 1938.

<sup>b</sup> The operation of this agreement was suspended as of Apr. 22, 1939.

<sup>c</sup> The Agreement will enter into force 30 days following exchange of instrument of ratification and proclamation.

(Source: *Foreign Commerce Weekly*, September 12, 1942)

“favored-foreign-nation” treatment, i.e., non-empire nation.<sup>7</sup> According to the original agreement, over 800 American export commodities were benefited. Twenty American export items were transferred by Canada from the dutiable to the free list, and 69 items received special duty reductions below the previous most-favored-foreign-nation rates. On still other articles rates were guaranteed against increase. Among the specific reductions in duty were those on fresh fruits and vegetables, automobiles, industrial equipment, railway cars and parts, gasoline and lubricating oils, and cotton fabrics. The decrease in the rates resulting from the agreement, in comparison with rates previously in effect on American goods, ranged in most cases from one-tenth to one-half. Transfers to the free list included potatoes, oranges (for part of the year), and tractors. Raw cotton was bound to the free list.

In return for these concessions, the United States by tariff reductions benefited about two-thirds (by volume) of Canada's total exports to this country. Reductions in duty were made on fixed quotas of cattle, potatoes, lumber, and some timber, the pact reducing by one-half the combined duty and tax on Douglas fir and western hemlock. The reduction on whiskey was also the full 50% allowed by the law. Perhaps the greatest favors to Canada, however, were the promises that her most important exports—newsprint, pulpwood, and woodpulp—would be kept on the free list. The subsequent revision of the Canadian agreement provided for more and deeper reductions.

Another important trade agreement was that concluded with France, signed in May, 1936, and also that with the United Kingdom in November, 1938. The war interfered with the trade agreement program, but in spite of the war, agreements were signed with some of the Latin American countries.

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<sup>7</sup> Canada has a three-rate tariff system, providing for minimum, intermediate, and maximum schedules. Minimum rates are available only to nations belonging to the British Empire, conventional or intermediate rates are granted to nations with which trade treaties have been made, while maximum rates apply to others. Unconditional “most-favored-foreign-nation” treatment therefore simply involves the extension of the conventional rates. Prior to the effective date (January 1, 1936) of the Canadian trade agreement, imports into Canada from the United States were subject to the maximum rates.

## CHAPTER 28

### COMMERCIAL POLICIES

**Economic Nationalism.**—One of the outstanding developments of the inter-war period, and particularly of the depression which began in 1929, was the strong shift toward economic nationalism and self-sufficiency, toward autarky<sup>1</sup> as it is sometimes called. Most countries, especially the European countries, pursued during this period increasingly restrictive trade policies, endeavoring to shut themselves off from dependence upon other nations, and to diversify and build up their own economies on a closed basis in so far as possible. The policies often became mixed with political maneuvering and plans for aggression.

Several reasons account for this trend toward autarky. (1) It was in part the outgrowth of rearranged borders and the consequent reorganization of production. The war had brought profound changes in markets, in the geographical distribution of production, in industrial technology, and in trade relationships. Industries had sprung up in areas where they previously had not existed and were now competing with older industries. New and old were demanding protection. International debtor-creditor and other financial relationships were altered, necessitating extensive readjustments in trade. The necessary readjustments, however, were impeded by the restrictive policies. With the advent of depression the maladjustments became intensified. (2) The trend toward economic nationalism was also the result of strong national feelings that had been aroused by the war. The philosophy of self-determination of peoples had defined more clearly ethnographic groupings, and had stimulated national loyalties. (3) Self-sufficiency was also promoted for military reasons. As rearmament and military preparedness pro-

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<sup>1</sup> The word is derived from the Greek *autarcheia* and refers to measures or a program aimed toward economic self-sufficiency.



ceeded, especially during the thirties, nations sought to minimize their dependence upon outside sources for what were regarded as war essentials. (4) The restrictive policy was encouraged by manufacturers and producers whose motives were not dissimilar to those of the protective group in the United States—producers who are always ready to urge protection of their home market. (5) The movement was also an effort by nations to insulate themselves from the adverse economic and political conditions in other countries. Some of the countries, such as Switzerland and Great Britain, turned toward autarky as a measure of self-defense in a chaotic world, rather than because they believed in its basic philosophy.

From the economic standpoint such policies, as would be expected, tended to reduce production and to suffocate foreign trade. Foreign trade all over the world found door after door shut or only partially open. Such policies interfere with the gains that come from specialization and trade, and are contrary to economic expansion. They tend to retard progress generally.

The policy of the United States during this period contributed to the international maladjustments, and to the movement toward self-sufficiency. In the first place, the isolationist policy of the United States was the American counterpart of European economic nationalism. Furthermore, this country carried its traditional policy of protection to new extremes with the passage of the Fordney-McCumber Tariff Act of 1922 and the Hawley-Smoot Tariff Act of 1930, both involving steep tariff increases. These high tariffs were particularly inconsistent with the creditor position of the United States. This country had become the leading creditor of the world, but its tariff policy interfered with the shipment of goods to America in payment of interest and principal.

Huge gold importations thus came to the United States in lieu of goods. Europe was left relatively short of gold, and its currencies were later unable to meet the strains of the depression. Moreover, the American protectionist policy aroused retaliatory action on the part of many countries, and set the pace for further restrictions to world trade. In 1932, Great Britain de-

cisively committed itself to a protective program.<sup>2</sup> With the introduction of other types of trade restriction, tariffs shrank relatively in importance, so that in many cases they ceased to be of primary significance in import control. These other restrictions were added to tariffs and were never in substitution for them.

As exports declined, accompanying increasing depression and trade restrictions, many nations found themselves with an inadequate supply of foreign exchange. They accordingly endeavored to cut imports sharply by various types of restrictive devices in order to reduce the demand for foreign bills and thereby maintain accustomed exchange rates, or in order to check further exchange depreciation. Exchange control, clearing agreements, and other devices made matters worse and all but stifled foreign trade.

**Methods of Autarky.**—The more prominent of the autarkic and restrictive trade measures, apart from tariffs which they to a large extent supplant, which were characteristic of this period were as follows:

(a) **QUOTAS.**—Toward the end of 1931 there came into wide use the practice of limiting the amounts of certain commodities that could be imported. These quotas were usually coupled with licensing arrangements, whereby official permission was required for certain import transactions. France was the first country during this period to employ the quota method, and before long other European countries followed its example—sometimes, however, in retaliation.

The early quotas, including those of France, were generally allocated among the principal trading countries in proportion to these countries' share in the quota nation's trade during some previous unrestricted period. The quotas were at first adopted as defensive measures, principally in connection with exchange difficulties, and were regarded as of a temporary character. It was not long, however, until quotas came to be used as aggressive tools for political purposes. The quota system is discussed further in Chapter 30.

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<sup>2</sup> British rates were not high but involved a marked increase from the free trade status, and were applied at a time when the currency was depreciated in the exchange market.

(b) **EXCHANGE CONTROL.**—Another method which has been effectively employed in limiting imports is governmental control over the purchase and sale of foreign exchange. When exports declined, many nations were faced with a shortage of foreign exchange. The result of the scarcity in the supply of foreign bills was a steady outflow of gold, where gold was available, a shrinkage in foreign balances, and a tendency for the country's currency unit to depreciate in the foreign-exchange market. Government rationing of the exchange supply was therefore adopted with the hope that rates would be stabilized. To purchase foreign goods it was, therefore, necessary to obtain a license, which might or might not be issued.

Such procedure, although helpful in dealing with temporary and extreme situations, ignored the fact that exchange depreciation was the logical remedy for the situation, in that a higher price of foreign drafts would tend to check imports and to stimulate exports; also that exchange depreciation might reflect new price-level relationships and that artificial control could not hope to maintain rates which were out of line with fundamental equilibrium conditions. Such efforts may do much harm. The official rates were often evaded, and much illegitimate trading took place.

It was not long before exchange control, at first used to protect gold reserves and exchange rates, was employed supplementary to tariffs as a means of restricting imports. Control, through licensing, over the purchase of foreign exchange permitted regulation of the nature and amount of imports. The device was a powerful political weapon. Exchange control is discussed in Chapter 29.

(c) **CLEARING AGREEMENTS.**—The drastic decline in world trade and the breakdown of foreign-exchange machinery led to substitutes for the customary methods of trading. According to the clearing agreement system, the two countries parties to the agreement—the agreements were usually bilateral—arranged that the importers in each country pay their money into a clearing fund, probably in the central bank, out of which fund the exporters would be paid. For the trade in question it was thus

not necessary to buy foreign exchange in either country. Clearing agreements provided another method of regulating the nature and direction of a country's trade. Clearing agreements are discussed in Chapter 30.

(d) CURRENCY DEPRECIATION AND DEVALUATION.—When a nation cheapens its monetary unit in the foreign-exchange market, it becomes more profitable for foreigners to buy that nation's goods, and less profitable for nationals to buy goods abroad. For example, when the Japanese yen fell from about 50 cents at the end of 1931 to 20 cents in 1932, Americans found Japanese goods much cheaper. In Japan, however, American goods became more expensive. When a nation's currency becomes depreciated, the high price in such a country of foreign currencies encourages exporters, since the foreign bills they have for sale yield them a larger amount of local currency than formerly. Exports are thereby stimulated, with the result that the tariffs of other countries temporarily lose much of their effectiveness. The practice of stimulating exports by such methods is sometimes called "exchange dumping."

Currency depreciation arouses strong resentment in other countries. The stimulation of Japanese exports, caused by the depreciation of the yen, was the occasion for bad feeling in the United States and elsewhere. Like the various restrictive devices discussed above, currency depreciation tends to lead to protective measures and retaliation by other nations. Its effects may be temporary, however, since if costs rise in the country with the depreciated exchange the stimulus to exports tends to disappear.

(e) IMPORT SURTAXES.—Several countries have established surtax systems, in which special taxes on dutiable imports are levied in addition to the regular duties. Certain articles are sometimes exempted from these taxes. During the depression, France and some of the gold-standard nations ordered the payment of surtaxes on imports from countries with depreciated currencies, in order to offset the exchange advantage. Surtaxes have also frequently been used by Latin American nations to provide revenues for specific purposes.

(f) **SANITARY REGULATIONS.**—Sanitary regulations have been established during recent years for disguised purposes, not being applied primarily in the interest of public health but as a means of restricting imports. Argentina is convinced that the American prohibition against the importation of Argentine beef is not because of the danger of hoof and mouth disease so much as to protect the market for domestic beef. American cattle growers, on the other hand, fear a serious outbreak of the disease such as occurred in the twenties. Regardless of the merits of this controversy, sanitary regulations can be and are used to restrict trade. Unreasonable sanitary measures usually cause bitterness in other countries, and have led on occasion to reprisals.

(g) **LABELING REQUIREMENTS.**—Exacting or unreasonable labeling requirements, like excessive sanitary regulations, invite resentment and retaliation. Thus, rather rigid American labeling regulations have caused other countries to impose severe requirements in connection with the labeling of American articles. Labeling regulations are sometimes altered without adequate warning, causing severe losses.

(h) **MISCELLANEOUS RESTRICTIVE MEASURES.** — Other forms of foreign trade restriction include bounties, or subsidies, to domestic producers, so-called anti-dumping duties, mixing regulations, and certain types of internal taxation. Government subsidies may take the form of production bounties, or export bounties. Both of these give the domestic producer a competitive advantage. A production bounty stimulates domestic production and discourages imports of the subsidized commodity. In its effect it is not unlike a tariff. An export bounty stimulates exports, and can hardly be called a trade barrier. Several nations now have "anti-dumping duties" which are levied upon imported goods sold at less than their market prices in the country of origin. Other nations give more or less arbitrary powers to the Executive to deal with dumping. The United States Tariff Act of 1922 provides that,

If the purchase price or the exporter's sales price is less than the foreign market value (or in the absence of such value than the cost

of production), there shall be levied, collected and paid, in addition to the duties imposed thereon by law, a special dumping duty in an amount equal to such difference.

In certain cases, anti-dumping duties have more than compensated for price differentials.<sup>3</sup>

Certain countries have introduced so-called "milling quotas," or mixing regulations, as a restrictive measure, requiring that all domestic flour be milled from blends containing a stipulated percentage of home-grown grain. Similar to these are "linked-purchase" regulations, which require for every import a fixed proportionate purchase of domestic articles. Several European nations have required that foreign moving picture films be shown only alongside domestic films. Internal excises on products depending largely on imported raw materials for their manufacture are, in effect, the same as tariffs, and may be levied for no other purpose than the exclusion of the foreign commodities involved.

**Commercial Treaties.**—Commercial relations between nations have long been governed to a large extent by treaty. As early as the sixth century before Christ, an important commercial treaty was concluded between Rome and Carthage. British trade treaties date back at least as far as 1217. Commercial pacts of the present day cover a variety of subjects, relating not only to trade but to such matters as smuggling, customs procedure, travel and residence, emigration and immigration, patent and copyright protection, harbor regulations and fees, as well as the rights of consular officials.

Like other treaties, commercial agreements may be unilateral, bilateral, or multilateral. In a *unilateral* agreement, only one of the contracting parties grants concessions or accepts obligations. Treaties in which the obligations were largely unilateral were often forced by stronger nations upon weaker states. The *bilateral* treaty is a much more common form and is one in which generally both nations accept similar obligations or grant similar privileges. *Multilateral* treaties, which are sub-

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<sup>3</sup> For cost calculations on dumping, cf. page 171.

scribed to by several nations, are becoming of increasing importance in international economic relations. They have dealt mainly with cable and radio matters, international postal charges, and weights and measures; multilateral agreements have also related to world supplies of silver, wheat, and sugar, as well as to currency stabilization.

Commercial treaties, usually bilateral, have been concerned primarily with tariff arrangements. *Reciprocity*, a term often employed in this connection, occurs when two countries grant mutual trade concessions. The term is used frequently in the United States to mean exclusive concessions given and received, as opposed to generalized concessions. Sometimes it is used to mean identical rates or exemptions extended by two countries on the same articles. The United States is at present engaged in a reciprocal tariff program, already considered. The policy opposite to reciprocity is retaliation, which consists of the erection of trade barriers by a country as "punishment" for similar action by another country or countries. Retaliatory trade measures were a conspicuous feature of the world depression, particularly as repercussions of the high Hawley-Smoot tariff adopted by the United States in 1930.

In recent years, commercial treaties have often been secret, and have tended to become more complicated.

**The Most-Favored-Nation Principle.**—An important provision in almost all commercial treaties of the past few decades is the so-called *most-favored-nation* clause. This clause guarantees that all concessions granted by either of the contracting nations to a third nation shall be immediately extended to the other contracting nation.

Most-favored-nation clauses are of two types—*unconditional* and *conditional*. The more liberal of these is the unconditional, which assures that both contracting states will automatically and unconditionally extend to each other all favors granted to a third nation, without regard to any favors awarded by the third nation. The conditional most-favored-nation clause guarantees that the two contracting nations will extend to each other all favors granted to any third nation, on the condition that

each contracting nation extends to the other privileges equivalent to those received from the third nation.

Until the first World War, the United States employed the most-favored-nation principle in its conditional form, whereas European countries, after 1860, made general use of the unconditional type. Since 1923, however, the United States has extended unconditional most-favored-nation treatment, while Europe has evaded the unconditional most-favored-nation clause in many ways, denying its application to quota and other restrictive devices. The conditional clause, however, has not reappeared, with one or two minor exceptions—the tariff clauses continuing to be unconditional most-favored-nation.

It is easy to see that the most-favored-nation principle, especially in its unconditional form, promotes equality of treatment. A nation which enters into unconditional most-favored-nation tariff treaties with other countries is thereby compelled to grant equal tariff treatment to all those countries. However, with respect to any particular commodity, a tariff concession benefits the countries very differently, depending upon the extent to which the country exports the commodity in question. This variation in benefit permits tariff bargaining under the unconditional most-favored-nation principle, as discussed below. The extension of the principle tends to simplify tariff arrangements. A short-run effect is to make for freer trade, but since 1875 the unconditional most-favored-nation clause has coincided with a steady and wide growth of protective tariffs. It is not, therefore, necessarily a free trade device, although it has been and can be used for this purpose.

**Reciprocity and Tariff Bargaining.**—The subject of reciprocity and international bargaining for trade concessions and tariff reductions has been previously referred to. Reciprocity is by no means a new development in international relations, but the world depression did much to give the movement new vigor and purpose. Those nations whose economic well-being was inextricably linked with the volume of their foreign trade were not slow to recognize the evils of growing trade restrictions. They therefore sought to explore the possibilities of



trade bargaining. Bilateral negotiations were undertaken by many countries with the hope of lessening the growing international commercial chaos.

By 1934 all but two countries on the Continent, as well as Great Britain and several Latin American republics, had authorized the executive branch of their governments to negotiate duties below those provided in the general tariff schedules. In Canada, France, Germany, Poland, and the United States, the Executive was empowered to proclaim bargaining agreements without referring them to the legislature. The American Trade Agreements Act of 1934 gave the President extensive powers for entering into reciprocal pacts with other countries.

Along with the advantages of bilateral trade agreements are a number of possible disadvantages. The negotiation of such agreements apparently led, in some cases, to so-called "bargaining tariffs," whereby a nation, anticipating a reciprocal treaty, raised its tariff so that when reduced by the trade agreement the tariff would be approximately as high as before. In the second place, the concept of reciprocity sometimes leads to the notion that trade between any two nations should balance, a notion which has often been expressed in attempts to equalize the imports from a given country with the exports to it. The idea of a bilateral balance, that imports and exports must balance between any two countries, is of course a fallacy. In the normal course of world trade no such situation prevails. Furthermore, tariff bargaining encourages the fallacious idea that any reduction of duties is a national sacrifice, and that when such a concession is granted, the home country should be sure to receive greater benefits from abroad or else a net loss is suffered. A reduction of duties is, of course, ordinarily desirable and beneficial to the country reducing the duties, entirely apart from favors received from other nations.

Simultaneous with the revival of tariff bargaining was a hesitancy, noticeable particularly in Europe, regarding the value of the unconditional most-favored-nation principle, wherein nations grant without reservation their most favorable trade concession to all countries entitled to them by treaty. This was due to the fact that countries with which previous unconditional

most-favored-nation treaties had been concluded could demand benefits issuing from the bilateral trade agreements without themselves doing anything in return.

This difficulty is more imaginary than real, since ordinarily no concession is made to any country except in respect to articles that are imported chiefly from that country. Equality of treatment of all countries is thus maintained, and yet the benefits of the concessions accrue largely to only the two bargaining countries. This fact reconciles the unconditional most-favored-nation principle with tariff bargaining.<sup>4</sup>

All nations are cautious in making concessions which are automatically extended to all competitors (i.e., at least to countries with which most-favored-nation agreements exist), and with considerable regularity have confined tariff concessions to commodities of which the foreign nation in question is the principal source. This policy does not restrict negotiations as much as is sometimes supposed. A tabulation of dutiable imports into the United States in 1931 showed that on the average 71% of each imported article came from the country which was the chief supplier of that product.<sup>5</sup>

The most-favored-nation principle, until interrupted by the outbreak of war, was showing much vitality, largely because it is conducive to equality of treatment. The more widely this principle is applied, the greater is the number of nations that are placed on the same basis. Nations object strenuously to discriminatory treatment, even though they may insist on the right to receive and grant special preferences in a few particular cases. The reciprocity program of the United States is based on the principle of equal treatment, the only exceptions being: (1) with Cuba, with which this country has long had a preferential arrangement, and (2) with Germany and Australia.

**British Commercial Policy Since 1914.**—From about the middle of the last century until the first World War, Great Britain maintained a policy of practically complete freedom of foreign trade. The country was frequently pointed to as a

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<sup>4</sup> Benjamin B. Wallace, "Tariff Bargaining," *Foreign Affairs*, July, 1933.

<sup>5</sup> *Ibid.*

nation which proved in practice the theoretical advantages of a non-restrictive and non-discriminatory commercial policy. The first World War, however, changed this policy. It strengthened the demands of the Conservative Party for a tariff-protected Empire, and brought new arguments of military necessity. Furthermore, the war was followed by changes in markets and technology which tended to depress British economic life, at first acutely, then chronically.

For several centuries prior to the repeal, in 1846, of the Corn laws (customs duties upon grain), England had restrictions upon the importation of foreign goods. After the repeal of these laws, sentiment for free trade was strong, and the British tariffs were abolished by successive steps, mainly by the Acts of 1853 and 1860.

In 1915, as a war measure, duties of  $33\frac{1}{3}\%$  ad valorem were levied on certain luxuries, ostensibly to conserve shipping space. These duties are commonly known as the McKenna duties, after the Liberal Chancellor of the Exchequer, Reginald McKenna.<sup>6</sup> The McKenna duties were continued after the war (except for a brief interval under the first Labor Government), and signalized the first important break in British tariff policy in almost a century.

The next important development in British tariff policy was the beginning of imperial preference in 1919; then came the passage of the Safeguarding of Industries Act in 1921. Imperial preference is discussed below. After the war, exchange rates on most of the continental countries were greatly depreciated because of inflation and economic disturbances. Goods of these countries became accordingly cheap in Great Britain, and interfered temporarily with British producers. The Act of 1921 gave to certain "key industries" the benefit of a  $33\frac{1}{3}\%$  ad valorem tariff.<sup>7</sup> It also authorized the imposition of additional duties by the Board of Trade on "dumped" articles, in-

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<sup>6</sup> Commodities affected included automobiles, motorcycles, motion picture films, clocks, watches, and musical instruments.

<sup>7</sup> Protected articles included chemicals, optical instruments and optical glass, scientific glassware, radio tubes, scientific instruments and gauges, and tungsten and other rare metals.

cluding goods from countries with depreciated exchange. Empire goods were allowed to come in free.

Throughout the nineteen twenties and early thirties, the tariff question was a dominant issue in Great Britain. The two Labor Governments, advocating a policy of free trade, abolished or modified duties upon each accession to office, only to find the old duties reinstated or increased by the succeeding Conservative and National Governments.

By 1930, despite downward reforms of the 1929 Labor Government, Great Britain possessed a rather substantial array of customs duties, the system consisting of: (1) revenue duties on coffee, cocoa, tobacco, wine, etc.; (2) protective tariffs, such as the McKenna and Safeguarding of Industries duties; and (3) preferential treatment, which embodied lower rates or free entry to imports from the dominions and colonies. The total net revenue in 1930 from all these duties was £120,611,299, or \$586,955,000 at par of exchange—a little more than that obtained for the same year from tariff receipts in the United States. The amount of revenue received, of course, does not indicate the degree of protection afforded. For example, if the rates were raised and became very restrictive so as to shut out goods, the revenue might decline.

To cope with the world depression, a coalition government was formed under Ramsay MacDonald in August, 1931. In the parliamentary elections which shortly followed, this National Government was continued, representatives of the Conservative Party being much in the majority. New protective legislation was inevitable. It came first in the form of an "emergency measure" granting the Board of Trade discretionary power to levy duties up to 100% on products, the importation of which had markedly increased. This Abnormal Importations Act became law in November, 1931, passed by an overwhelming majority. The Board of Trade began immediately to use its new powers, and on the day the bill was passed issued an order fixing a 50% duty on 23 classes of imports.<sup>8</sup> The new duties

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<sup>8</sup> By December 17, 26 more classes had been added. Goods upon which new duties were imposed included cameras, clothing, cutlery, glassware, radios, certain textiles, and typewriters. Since the Abnormal Importations Act of 1931 did not

were effective, so that imports of affected articles practically ceased.

As the depression grew more severe, these protective measures did not satisfy the demands. After long and stormy debate, the Import Duties Act was passed on February 25, 1932, becoming effective on March 1 of the same year. The chief provisions of this measure were: (1) a 10% duty imposed on all imports except those already subject to a tariff or enumerated on the free list; (2) the establishment of a tariff commission (Import Duties Advisory Committee), with authority to recommend additional duties; and (3) preferences to imports coming from other parts of the Empire. No time limit was placed upon the operation of the act.

The most significant feature of the above law was that which related to the recommendations of the newly established Import Duties Advisory Committee. This body which was set up corresponds to the United States Tariff Commission, and has somewhat similar powers and duties. It is authorized to recommend the levying of supplementary duties, which, however, must be passed by Parliament to become effective. The committee may also advise the discontinuance of any additional duties imposed.

The committee soon came to the conclusion that the general level of protection should be about 20% ad valorem. On most manufactured goods, the United Kingdom rates therefore range from about 20% to 33⅓% ad valorem, with some rates higher. These measures established a tariff policy which abolished traditional British free trade.

**Imperial Preference.**—During the twenties and thirties tariff discussions in the British Empire were concerned with the matter of “imperial preference”—the granting of more favorable terms to imports from member nations of the Empire than to imports from other nations. Imperial preference by no means received the unanimous support of the British people.

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apply to food items, a Horticultural Products Act was passed shortly afterward authorizing the Minister of Agriculture to place emergency duties on out-of-season fruits, vegetables, and flowers. These duties were justified in Parliament on the grounds that the imports affected were of a luxury character.

It has been identified in England with the protectionist Conservative Party, and opposed by the Labor Party, which favors free trade. The Conservatives maintained that the British Empire was virtually self-sufficient as regards all essential commodities, and that an intra-imperial system of preferential tariffs would free member nations from dependence upon foreign good-will and commerce.

The preference principle was first accepted at the Imperial Conference of 1917, and in 1919 was put into practice by reducing, in favor of the Dominions and colonies, revenue tariffs which had long yielded a substantial portion of the government income, together with the protective McKenna duties. The Safeguarding of Industries Act (1921) carried the policy still further, since the  $33\frac{1}{3}\%$  tariff which it levied on certain "key" articles did not apply to imperial imports. In the Import Duties Act of 1932 specific provision was made for exemptions for all imperial products—i.e., from the duties imposed by this act. Earlier reductions under other acts were unaffected. In most cases the preference granted to imperial imports consists of free entry into the United Kingdom. This, of course, places products of member nations at a marked advantage over those of other countries.

Like Great Britain, the Dominions grant preferential rates to imperial products. Canada has a three-rate tariff system, the minimum schedule of which applies only to imperial imports. Australia and the Union of South Africa follow somewhat the same policy. The tariff law of New Zealand establishes a single column of rates for all products of non-British nations and another column of preferential rates for imperial goods, but concessions from the higher rates have been made to certain other countries.

Since 1907 numerous imperial conferences have been held, attended by the Premiers of Great Britain and the Dominions. These gatherings had no legal powers, and the procedure consisted of the embodiment of such agreements as could be arrived at, in the form of resolutions. It was then the task of the conferees to work for the acceptance of such resolutions by their respective home governments.

The first World War established the equality in status of Great Britain and the Dominions. Consequently, Great Britain was no longer in a position to dictate policy in imperial affairs. At the Imperial Conference held in Montreal in 1926 this principle of equality was formally recognized in the Balfour Report, which declared that Great Britain and the dominions "are autonomous communities within the British Empire, equal in status, in no way subordinate to one another . . . though united by a common allegiance to the Crown, and freely associated as members of the British Commonwealth of Nations." In 1931 this principle was embodied in an act of Parliament, the Statute of Westminster.<sup>9</sup>

An important imperial conference was that held at Ottawa, Canada, in July and August, 1932. The world economic situation at that time was in a precarious state, and Great Britain and the Dominions sought to improve imperial conditions through an exchange of trade concessions. A dozen bilateral trade agreements were concluded, known as the Ottawa Agreements, which, however, fell short of the more optimistic hopes. There was considerable evidence of intra-imperial rivalry, and favors were demanded with far more enthusiasm than they were offered. The chief concessions were granted by Great Britain, which had entered the conference in a strong bargaining position as a result of the passage of the Import Duties Act a few months before.

The British Government agreed to continue for five years the provision of the 1932 tariff act, by which most Empire products enter Great Britain duty free. Promise was made, moreover, that further preferences would be extended to certain agricultural products of the Dominions through the enactment of new or additional tariffs against competing products of foreign countries. Among the principal Dominion products granted preferential treatment were wheat, dairy products, certain fruits, cattle, meat, fish, tobacco, copper, zinc, and lead. Canada and Australia agreed to lower duties on many British articles, and not to raise tariffs except after a review of the

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<sup>9</sup> Arthur Berriedale Keith, *The Government of the British Empire*, New York, The Macmillan Co., 1936, pp. 33-34.

situation by tariff boards, Dominion boards to act after hearing the British case.

**France.**—Since the Franco-Prussian War in 1871, French tariff policy has tended increasingly toward greater protection of both manufactures and agricultural products. After 1853 France reduced her tariffs somewhat, but the country has never pursued a thoroughgoing free trade policy as has Great Britain. Until about 1927 the French tariff was relatively low, with a few exceptions, such as protection to the chemical industry. France long held to the principle of a high degree of self-sufficiency, and never was particularly outstanding as a trading nation. Foreign investment interested France especially when political advantages were involved. French public opinion was nationalistic and protectionist, both farmers and manufacturers believing that such a policy for France was a necessity.

The French tariff system, as it existed in 1939, provided for maximum, minimum, and intermediate rates of duty. The maximum and minimum schedules dated from the Tariff Act of 1892, which abandoned a general-conventional tariff system, and which also turned France more definitely toward protection. The recent minimum column was sufficiently high to afford the desired degree of protection, and was mainly applicable to products of countries with which treaties giving France equivalent concessions had been concluded. The United Kingdom, however, received minimum rates without any treaty concessions. The maximum column, providing in most cases for rates about four times the minimum, was used largely for bargaining.

Prior to 1914, France generally extended, or withheld, the minimum tariff as a whole, and only gradually were intermediate rates introduced. Exports from the United States were treated differently in that most of America's chief exports were granted French minimum rates. Many of the less important American exports, however, were subject to the maximum rates. By an agreement in 1910, those American products to which the maximum rates applied were exempted from tariff increases just made, thus becoming subject to intermediate rates. In the 1936



trade agreement with the United States, most of the intermediate rates previously applying to American products were eliminated, minimum rates being substituted.

In 1931, France established a quota system for the purpose of exercising greater control over imports, particularly agricultural imports. At first the quotas were distributed among the leading trading countries according to the volume of their trade with France in previous years. In September, 1933, however, the French Government announced that only one-fourth of the quota allotments for 1934 would be granted on the former proportional basis, the remaining three-fourths being granted to such nations as would extend corresponding advantages to French exports. It thus became a bargaining tool. On January 1, 1934, the new policy was applied not only to articles previously on the quota list but to hundreds of new items which were added to the list at that time. Although France had unconditional most-favored-nation agreements with most of the nations of the world, it took the position that most-favored-nation treatment did not apply to the quota system.

**Germany, Italy, and Russia.**—Germany, Italy, and the Soviet Union had, in 1939, intricate systems of import restriction in which tariffs played a relatively minor rôle. Foreign trade was regarded largely as a means of obtaining materials for armaments and of furthering political objectives. These totalitarian states exercised by one device or another complete control over foreign transactions, as well as over the details of domestic economic life. We shall not attempt to discuss their system here.<sup>10</sup>

**The Netherlands, Belgium, and Switzerland.**—The Netherlands, prior to 1939, had for many years a single-column tariff system. Reductions which it granted in trade agreements were automatically extended to all countries, regardless of treaty relations. As the tariff rates of the Netherlands have always been low, other nations seldom pressed for tariff concessions. During the depression, however, a few favors were granted,

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<sup>10</sup> United States Tariff Commission, *Extent of Equal Tariff Treatment in Foreign Countries*, Report No. 119, Second Series, 1937, p. 52.

consisting almost invariably of guaranties against increase rather than of reductions. While during the depression the Netherlands maintained equality of treatment with respect to tariffs, it followed the example of France in regard to its new quota system, employing the latter largely for bargaining purposes. The Netherlands provided no tariff preferences for the products of its colonial possessions, although as a rule it exempted such products from all or part of the import monopoly fees.<sup>11</sup>

The policies of Belgium and Switzerland in 1939 were similar to that of the Netherlands. While the Belgian tariff law provided for maximum and minimum rates, the maximum rates were solely for penalty purposes. Tariff reductions granted in a trade agreement to a particular country were immediately extended to all other countries. After 1931, Belgium maintained a system of quotas, which were apportioned to the various countries according to the countries' share in the trade of Belgium during a previous period.

The tariff system of Switzerland, although technically a general-conventional system, is in practice that of a single tariff, since conventional reductions in duty are automatically extended to all countries. Switzerland also has a quota system, established in 1932. The war has, of course, altered the situation for Switzerland.

**The Scandinavian Countries.**—The three Scandinavian countries, Denmark, Norway, and Sweden, had, as of 1939, tariff systems which were remarkably alike. These countries were outstanding for the liberality of their commercial policies. Each country employed a single-column tariff, applying rates equally to all nations. Reductions granted in trade pacts were treated by each of the three countries as amendments to the single column, and hence were automatically extended to all other nations, regardless of whether most-favored-nation treaties had been concluded with them. Although both Denmark and Sweden had laws authorizing the levying of penalty sur-

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<sup>11</sup> See Chapter 29, "Exchange Control"; also Chapter 30, "Clearing Agreements, Quotas, and Bilateral Balancing."

taxes, the latter were seldom, if ever, applied. Prior to 1925, Norway had a two-column tariff, but in practice the maximum schedule was imposed only for penalty purposes. When granting most-favored-nation treatment, the three countries generally reserved the right to except concessions made to each other, but no preferential arrangements among these nations were made.

**The Latin American Countries.**—In the Latin American countries single-column tariff systems predominate. Mexico has a single tariff, rates on all like commodities being the same for all countries. Mexico maintains no quotas and does not practice exchange control. Other Latin American countries having single-column arrangements are Bolivia, Costa Rica, the Dominican Republic, Honduras, Paraguay, Peru, and Uruguay. The tariff of Argentina is also unilinear in practice, although the law provides for maximum and minimum schedules and for reductions below the statutory "minimum." The maximum rates are applied for penalty purposes.

A considerable number of Latin American countries have three-rate tariff systems, providing for maximum, minimum, and either intermediate or conventional rates.<sup>12</sup> Countries with this type of arrangement include Brazil, Colombia, Cuba, Ecuador, El Salvador, and Haiti.

Guatemala, Nicaragua, and Venezuela have general-conventional tariff systems.

**The Far East.**—China, although disrupted by the war, has a unilinear tariff system, equal tariff treatment being accorded to like products of all countries. No preferential arrangements are extended to any nation.

The customs tariff for many years was a matter of contention between China and foreign nations. From the Treaty of Nanking in 1842 until February, 1929, China did not possess authority to alter the rates of duty upon her imports and exports. The rate of duty was established at 5% ad valorem, and could not be changed except with the consent of

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<sup>12</sup> If conventional rates are provided for, these are generally below the statutory minimum, in which case the "minimum" rates are really the intermediate schedule.

the various foreign powers. After negotiations spread over several years, China's right to tariff autonomy was recognized in principle at the Peiping Customs Conference in 1925. Having concluded new tariff treaties with all the treaty powers except Japan, China issued a new tariff schedule, to be effective February 1, 1929. Before this schedule went into effect Japan also agreed to the arrangement, and in May, 1930, a formal treaty was signed.

Japan, like China, has had an essentially single-tariff system. While Japan granted conventional reductions in a few instances, it had unconditional most-favored-nation agreements with almost every country. Japan's tariff legislation, like that of many other countries, provided for the levying of penalty surtaxes (up to 100%) on imports from countries which discriminated against Japanese shipping or trade. On a list of so-called luxuries, the Japanese import duty was 100% ad valorem.

## CHAPTER 29

### EXCHANGE CONTROL

The period between the two World Wars was one of profound changes in governmental policies and practices with respect to foreign trade. It was a period when nations, following programs of narrow economic nationalism, placed more and more restrictions on the flow of goods and services, aiming to bolster and rearrange their own economies regardless of the effects upon other nations. This was particularly the case during the disturbed period of world depression. The mounting restrictions tended to retard recovery and to cause further maladjustments, thereby inducing still more restrictions.

The first World War was followed by extensive changes in political boundaries, in the channels of trade, in the pattern of production, in industrial technology, and in most international economic relationships. The readjustments which were necessary—difficult under any conditions—were impeded by the restrictive policies pursued. Dislocations led to further dislocations—a vicious circle ending in almost complete collapse and finally in world conflagration. Economic nationalism, partly an outgrowth of the national feelings aroused by the first war, had seemed an escape from the disturbed world outside, but added fuel to the fire.

The policy of the United States during these years, unfortunately, contributed to this trend and to the widespread maladjustments. The United States withdrew from world affairs, following provincial isolationism, and also carried its policy of protection to new heights with the passage of the Fordney-McCumber Tariff Act of 1922 and the Hawley-Smoot Tariff Act of 1930. These extremely high tariffs, in addition to setting the pace for other countries, were inconsistent with the creditor position of the United States. The United States had

become the leading creditor nation, but its tariff policy made difficult the shipment of goods to it in payment of interest and principal. Huge gold imports thus came to the United States in the place of goods, permitting the inflationary boom and speculation of the twenties on this gold base.

The ensuing world depression accentuated the trend toward economic nationalism, causing nations to attempt to insulate themselves against the adverse economic and political conditions abroad. Nations aggressively sought to achieve as large a measure of self-sufficiency as possible. The disruption in foreign trade created disturbances in the balance of payments which left some nations short of foreign exchange while others had balances abroad that could not be transferred. Nations with an inadequate supply of foreign exchange, particularly debtor nations with obligations to be met in foreign currency, accordingly endeavored to curtail imports by various devices. Their aim was to reduce the demand for the dwindling supply of foreign exchange and prevent further depreciation.

Tariffs were no longer the main reliance in shutting out foreign goods, but were overshadowed by more direct methods, such as the establishment of import quotas, sanitary regulations, licenses, control over exchange rates, and various bilateral arrangements. These measures aggravated the situation and contributed to the virtual collapse of world trade.

The revival of trade, which accompanied recovery from the worst phases of depression, did not lead to abandonment of the new methods of control. Although there was some relaxation, these devices were adapted to new purposes and came to be regarded as more or less permanent features of the international economic order. Most economists opposed them, but a few economic writers regarded favorably certain features of the new methods.<sup>1</sup>

**Exchange Control Prior to 1930.**—The term “exchange control” refers to governmental regulation of the rates and supply of foreign exchange. Inasmuch as the original purpose of lim-

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<sup>1</sup> See, for example, Paul Einzig, *The Exchange Clearing System*, London, Macmillan & Co., Ltd., 1935.

iting depreciation, stabilizing rates, and allocating the supply of exchange to essential purposes soon was subordinated, in most European countries at least, to the manipulation via exchange rates of the country's foreign trade so as to alter the domestic economy and to implement foreign policy, the term "exchange control" came to have a connotation of perhaps uneconomic control or control for some ulterior purpose. It is used, therefore, in distinction to "exchange stabilization" which means merely what these words imply and no more.

Exchange control in the simple and original sense assumed importance during the first World War especially for the purpose of preventing depreciation. Before the war, however, central banks long engaged in operations designed to affect exchange rates indirectly. Thus, changes in the central bank's discount rate were often for the purpose of influencing gold movements and preventing pressure against exchange rates. Another pre-war form of exchange regulation, commonly known by its German name, *Devisenpolitik*, was employed by central banks to minimize seasonal fluctuations in exchange rates. This was accomplished by purchasing foreign exchange during the export season when it was plentiful and selling it during the import season, with the aim of equalizing the rates. Generally speaking, however, exchange control was of little importance during this period and rates were largely left to their own devices. The leading nations of the world were on the gold standard, and so long as the gold standard functioned fairly smoothly, as it usually did (at least on the surface), there was little apparent reason to disturb its automatic mechanism by resort to artificial measures.

When the gold standard was abandoned on the outbreak of the first World War, direct action in the exchange market became necessary if the exchange depreciation was to be halted. In 1915, the British Government authorized the New York banking firm of J. P. Morgan & Company to buy all sterling exchange offered to it, at the fixed rate of \$4.7640 per pound. Funds for this purpose were originally provided by the British Treasury through gold shipments, the mobilization of British dollar securities, and borrowings in the United States. After

the United States entered the war and until the so-called "pegging" was discontinued in March, 1919, funds were supplied by the United States Government in the form of loans to the British Government. As a result of these operations the rate for sterling remained rigidly fixed. The French franc and the Italian lira were also pegged by similar means.

Indirect measures were taken during the war to conserve supplies of foreign exchange. The so-called McKenna duties adopted by Great Britain in 1915, consisting of levies of 33% upon automobiles, musical instruments, and other luxury articles, had as one of their main objectives the conservation of foreign-exchange resources. Capital exports were prohibited by France and other countries for the same reason. The pegging of the pound and the franc was discontinued in 1919, and embargoes on the export of capital were relaxed, although later re-instituted. Thus Great Britain in 1924 placed an embargo on foreign capital issues preparatory to returning to gold in 1925.

During the period of currency chaos in Europe in the years immediately following the war, exchange rates fluctuated widely. In spite of the extreme fluctuations and depreciation, governments seldom intervened in the exchange market, nor was much done in other ways to control the rates. It was a period of severe price inflation and erratic exchange movements, which were intensified by the flight of capital, by operations of speculators, and the general economic disorganization. Rates were left to fluctuate almost without any interference, and the philosophy of "flexible exchange rates" had free play.

As budget deficits gradually became reduced, currency inflation was checked and the general economic deterioration halted. Prices then became more settled, and exchange fluctuations accordingly narrowed. Governments, usually through the central bank, began to control rates by means of direct purchase and sale of foreign currencies. As rates became more stable, and as confidence returned and refugee capital sought repatriation, central banks accumulated generous supplies of foreign-exchange, or gold, and were, therefore, in a strong position to control the rates.



Most countries returned to what was called the gold standard. A fixed relationship to gold was established and was maintained by the use of balances in New York or London. Drafts on these financial centers were sold freely at the fixed rate for local currency, and since dollars and pounds were redeemable in gold the effect was to establish parity with gold. It can be seen that this was a type of gold-exchange standard, and was secure so long as the United States and England were able to pay out gold freely. This type of standard, however, interfered with the so-called automatic or self-regulating forces of the gold standard, particularly in view of the way countries tended to divorce domestic currency and fiscal policy from the condition of the foreign-exchange reserve and the balance of payments. Out of this situation grew the tendency to pursue a policy directed toward domestic economic ends, regardless of the effect upon exchange rates.

Exchange control during this pre-depression period was based essentially on the purchase and sale of bills by the official agency at the fixed rate, and involved little or no restriction upon the amounts of foreign currency which could be bought by the public, nor upon the use to which such foreign currency was to be put. No license was required to purchase a foreign bill. Capital was thus relatively free to go abroad at will.

**Exchange Control During the Thirties.**—The depression of the nineteen thirties changed this situation drastically. Foreign balances, or gold reserves such as they were, became depleted, and countries began to limit the sale of drafts, rationing the supply according to standards developed as they went along. Extensive foreign loans and credits had been extended during the previous decade by the United States and Great Britain, especially to European and Latin American countries, and had accordingly made a large supply of dollars and pounds available to these other countries. Most countries followed the practice of linking their currencies to either the pound or the dollar, and were aided in maintaining a fixed relationship to these currencies through the large volume of loans that had been extended. When lending came practically to an end, and foreign

trade declined, the supply of foreign exchange was consequently greatly reduced.

As depression gripped the world the growing economic strains and disequilibria put too great a burden upon Great Britain's gold reserves, with the result that in September, 1931, Great Britain left the gold standard. Balances in London could not be withdrawn in gold, and the pound consequently became immediately depreciated, causing currency confusion everywhere.

London had long been a financial center where transactions all over the world were financed and cleared. Practically all leading banks which engaged in international financial operations maintained sterling balances there through which transactions were cleared and settlements made. When England left gold and this system broke down, currencies all over the world were left in a state of confusion which became especially severe after dollar devaluation commenced in 1933. Fluctuations in currency relationships were wide and in some cases the depreciation was considerable.

The scarcity of dollars and other foreign currencies was particularly acute in debtor countries with interest and principal payments to make on their obligations owed abroad, and payable in foreign currency. The rise in exchange rates made the servicing of such obligations increasingly burdensome, in addition to the domestic burden of raising revenue during a period of depression and stagnant trade. Furthermore, the maintenance of a flow of necessary imports into these debtor countries found competition for the dwindling supply of foreign exchange, in the demands for debt service. The flight of capital seeking safety abroad added to the demand for foreign exchange and similarly tended to push up the rates. As a result of this situation, exchange control came as a logical development. It was basically an attempt to combat the consequences of nationalistic, monetary, and other policies and the unbalanced conditions which had accumulated during the preceding years.

The supply of foreign exchange was accordingly rationed among the potential buyers by various devices; official rates were established, and the way opened for manipulation of a

country's entire foreign trade and other transactions, encouraging certain transactions and discouraging or prohibiting others, with profound consequences upon the world's economy and political relations. Substitution of an administered system for a free or semi-free system, in such an important segment of the economy as centers around exchange rates, is inevitably bound up with major economic changes and has far-reaching ramifications.

The original purpose of exchange control was merely to protect exchange rates from depreciation, and to see that the necessary exchange was available to pay for the importation of essential goods and materials. Soon, however, exchange control was used as an instrument of economic warfare. In conjunction with clearing agreements, to which it logically led, it was used, particularly by Germany, to promote military armament, self-sufficiency, and to destroy the multilateral trading system of the free economies. Whether so designed or not, exchange control inevitably alters the production, trade, and economy of the country employing it, and of other countries as well.

Exchange control measures assumed a variety of forms. Some of the measures involved the purchase and sale of exchange by the monetary authority in a manner aimed to influence the rates, but most measures involved the fixing of an official rate or series of rates, licensing the purchase of exchange, since the official rates would be below the free demand and supply rate, placing restrictions upon the purposes for which exchange could be used, and the compulsory sale of exchange (a portion or all) to the government authority.

Exchange control of the first type, i.e., influencing the free rates, is not what is ordinarily understood by the term "exchange control," but is commonly known as "exchange stabilization." Such stabilization was usually accomplished through the medium of so-called stabilization funds consisting of gold and foreign-exchange holdings. The appropriate government agency would enter the market as either buyer or seller of bills according to the direction in which it wished to influence the rates. This type of stabilization, discussed in Chapter 14, is, of course, helpless against a persistent trend which would drain exchange

resources, and is useful only to eliminate some of the fluctuations, and also to squeeze speculators.

The form of exchange control which became almost universal during the nineteen thirties, the principal exceptions being the United States and Great Britain, was administered through a system of licenses for the purchase of foreign bills. Licenses were issued only for specified purposes, such as the importation of what were considered necessary articles and raw materials, as opposed to luxury goods. As part of this system governments required that the proceeds from exports be turned over to the exchange control office, the central bank, or whatever agency administered the plan. This latter requirement provided a supply of exchange, which could then be sold, under license, at the official rates. Governments in this manner established a monopoly or semi-monopoly over the purchase and sale of all foreign currencies.

Exchange restrictions such as these almost invariably led to the emergence of illegal markets—the so-called “black markets” or “black bourses,” where exchange was available, but at higher rates than in the artificially controlled markets. In the bootleg market exporters could obtain more for their bills, while buyers could get possession of bills for which licenses could not be obtained. In spite of efforts to suppress such dealings—in Germany the death penalty was provided for violations of the exchange regulations—black markets were difficult to eradicate. Trading was frequently exceedingly active and extensive. Exchange control thus opened the door for a large amount of corruption.

In most countries, not only one but several official exchange rates were established, different rates applying to different types of transactions. Thus there would be one rate for prime necessities, another rate for less essential articles, perhaps a third for debt remittances, a fourth for luxury articles, etc. This permitted selectivity and the discouraging of certain types of transactions. Even though an official rate was set for a certain type of transaction, this did not necessarily mean that exchange would be available for such a purpose. In the fall of 1942 the Department of Commerce listed seven different exchange cate-

gories for Chile, although some of the rates had then become identical. The war and resulting large purchases in Latin America by the United States, together with loans granted, increased the supply of dollars in the possession of Latin American countries, and eased considerably the pressure on exchange rates. Control was not relaxed, however, but licenses were issued more freely and rates exhibited more stability.

Export subsidies or aids in one form or another were extended during this period by the governments of practically all European countries. The purpose was largely that of acquiring free exchange. In addition, governmental credit facilities were usually available to promote exports. Export subsidies, or bounties, were used by Hungary and Rumania in conjunction with import surtaxes. The central banks of these countries granted substantial premiums on foreign exchange handed over to them by exporters, while levying surcharges on foreign exchange allotted to importers. Another method of increasing the supply of foreign exchange was that adopted by Italy, which compelled all citizens to surrender their holdings of foreign securities in return for government bonds.

**German Exchange Control.**—Prior to the outbreak of war, Germany developed exchange control procedures which were especially comprehensive and detailed. After September, 1934, German importers were required to secure a certificate from one of the government control boards for each individual import transaction. There were some twenty-seven of these control boards, each having charge of a different class of goods. These boards determined for what goods and in which countries the available supply of foreign exchange could be spent, and in this manner exercised complete control over Germany's import trade.

In conjunction with this system Germany devised various types of currency, such as "registered marks," "travel marks," "aski marks," etc. Each type of mark could be spent only for designated purposes, and arose from different kinds of transactions. For example, German concerns owing interest or principal on foreign obligations were required to pay such sums not in foreign currency, but in marks and into certain accounts

in Germany. These sums became the property of the foreign creditors who, however, could spend them only for certain purposes. The creditors might sell this blocked exchange, as it was called, in the foreign market, but this could be done only by accepting a substantial discount. "Registered marks" were those arising from balances in Germany owned by foreign creditors prior to 1931. Foreigners could use registered marks to import German goods, to invest in German securities or property, or to pay traveling and living expenses in Germany, but they could not take such funds out of the country. Special "travel marks" were sold to tourists at a large discount to encourage travel and thereby obtain possession for Germany of foreign exchange. Other types of marks could be used only for the purchase of certain long-term German securities, and could be disposed of only at a considerable discount.

So-called "aski marks" were widely held abroad and represented the proceeds from exports to Germany by foreign firms. Aski marks could be used for the purchase of German products, and for a time could be sold at a relatively small discount by the foreign exporter. Germany succeeded in pushing her foreign trade by making agreements, as noted below, particularly with Latin American and Balkan countries, to buy their goods on what appeared to be favorable terms, in exchange for aski marks. Germany was willing to buy from these countries at a time when other countries were not able to, because their exchange system had broken down. Germany devised ways and means of continuing to trade even though she was short of foreign exchange. As the countries to whom Germany sold, however, became surfeited with the German goods which they were allowed to buy, such as typewriters and harmonicas, aski marks depreciated and the foreign countries discovered that the deal was not as attractive as it had appeared.

By means of this complicated exchange system, Germany secured certain temporary advantages and succeeded in getting exports flowing during a period of stagnant foreign trade. The main purpose, of course, was that of obtaining in return essential materials, particularly those which were needed in connection with the preparations for war. The system also, by channel-

ing trade toward Germany, was damaging to outside countries, and tended to disrupt their regular trade, or what was left of it. The multilateral system of the free countries was thus interfered with to Germany's advantage.

The system also aided in the reduction of Germany's foreign indebtedness. The fact that interest and principal on foreign-held German obligations was paid in blocked marks, which could be used only for certain restricted purposes, greatly reduced the market value of these securities, and thereby made it possible for Germany to buy them back at a substantial saving. Partly for this reason, Germany's foreign debt was almost cut in half from 1933 to 1938.

**Exchange Control During the War.**—With the outbreak of war in September, 1939, regulatory measures were extended by the belligerent governments to cover those few foreign transactions which were not already under government supervision. The exportation of luxuries and semi-luxuries was completely prohibited, and restrictions on the importation of almost everything else were tightened. Many non-belligerent countries found it necessary to tighten their controls over foreign transactions.

The British system of exchange control, in addition to fixing rates and regulating all foreign transactions, endeavored to tie the currencies and foreign-exchange holdings of the countries of the so-called sterling area closely to the pound. The sterling area included most of the Empire, but not Canada, as well as certain foreign countries, such as the Scandinavian countries, whose trade and financial relations with England had long been especially intimate. Countries in this group for a good many years followed the practice of keeping their exchange rates with the pound relatively fixed. They also maintained their foreign-exchange reserves largely in the form of sterling balances in London, or in short-term securities there.

The war welded this group, apart from countries under German domination, even more tightly together than previously, particularly since British wartime exchange regulations were less strict for transactions between countries in the sterling group. Other members of the group followed the same pro-

cedure of relaxing regulations as among themselves. Thus within the sterling area, transactions could be settled with reasonable freedom merely through the transfer in London of sterling balances. Furthermore, and this is of special significance, Great Britain was enabled to buy anything within this group and pay for it with her own currency, thereby avoiding any drain upon her foreign-exchange resources. The group thus had what amounted to a single currency.<sup>2</sup>

Great Britain also developed a system whereby she was able to utilize for her own purposes the foreign-exchange holdings of the countries of the sterling area. These holdings helped to support the pound in relation to countries outside this group, and to pay for British imports, particularly from the United States. Countries in the sterling area turned over to Great Britain the foreign exchange which they received in their trade with outside countries. For this they would receive sterling funds in London, which were usually invested in Treasury bills or other government obligations.

Great Britain also promoted bilateral clearing agreements between sterling area countries and those outside the sterling area. According to these arrangements the non-sterling countries received payment in sterling in London for exports they sent to any of the sterling countries. These sterling balances could not be converted into the currency of the exporter, but could be spent only within the sterling area. Exporters to the sterling area were thus forced to sell for sterling.

Bilateral payments agreements of this type, which provided for settlement through "special accounts" and which were in effect bilateral exchange clearings, were concluded by Great Britain with a large number of countries including Argentina, Brazil, Portugal, Peru, Greece, Uruguay, Chile, and Spain. An agreement was concluded with twelve Central American, northern South American countries, and Mexico which differed from the above in that sterling balances could be freely transferred within this group.

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<sup>2</sup> The sterling area became practically coextensive with the British Commonwealth of Nations with the exception of Canada, Newfoundland and Hong Kong which remained outside, and Egypt and Iraq which remained inside.



In the case of the United States, however, exporters to the sterling area were paid in dollars rather than in blocked sterling. According to the "cash and carry" provisions of the Neutrality Act, American exporters were not allowed to sell to a belligerent on credit so that Great Britain was compelled to find dollars for her American purchases. This was done in three ways: (1) through the export of goods and services by Great Britain and other members of the sterling area, (2) through the sending of gold (both accumulated and new) to the United States, and (3) through the sale of British foreign assets. The inauguration of lend-lease operations under the Law of March 11, 1941, whereby the United States Government was empowered to advance defense materials to Great Britain and other countries, eliminated the urgency of finding dollar exchange.<sup>3</sup>

The war caused the piling up in London of sterling balances, owned within and without the sterling area, which it will be difficult for Great Britain to transfer in goods and services, particularly in view of the loss of so many of her foreign assets, and in view of her own urgent need for imports and therefore of exchange with which to pay for them.

On the continent of Europe the currencies of the countries dominated by Germany were tied rigidly to the German mark, and a system developed which aided Germany in the exploitation of these unfortunate countries.

Germany obtained imports from these countries without sending equivalent exports in payment through various measures, such as forced loans from the Central Bank of the occupied country, levying of so-called occupation costs, clearing agreements wherein mark balances were received for exports to Germany, and in countries occupied but not formally annexed, by the direct issuance of German currency known as Reichs-

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<sup>3</sup> Until the middle of 1940 American creditors were able to withdraw funds from the sterling area through the so-called free sterling market. In this market sterling that was owned abroad could be freely sold for dollars at rates which fluctuated widely and which, of course, represented more depreciation of sterling than the official rates. Such sterling could be used to withdraw investment funds from Great Britain. This condition ended when Great Britain tightened the restrictions in 1940. Exports thereafter to the United States and Switzerland had to be paid for in dollars or Swiss francs, or in sterling bought at the official rates. League of Nations, *World Economic Survey 1939-1941*, Geneva, 1941.

kreditkassenscheine, or credit notes. This currency was usually issued only during the early period of occupation of a country. It was replaced by local currency of the country which was obtained by the German authorities in any desired amounts, either through tribute or loans from the banks. In the areas formally incorporated into the Reich the local currency and the credit notes were soon withdrawn and replaced by marks.

Through clearing agreements, usually bilateral but in some cases multilateral, the countries under German occupation or domination exported heavily to Germany and accumulated large mark balances in Berlin. The rates of exchange, prior to occupation of these countries, had been fixed at levels which overvalued the mark and made the terms of trade especially favorable to Germany. After occupation some of the rates were lowered, thereby allowing for previous overvaluation of the mark. In the case of Belgium and especially of France, however, the rates were raised and the overvaluation of the mark thereby increased. Through these agreements and as a result of the rates which favored the mark, Germany was able to secure goods without a real *quid pro quo* payment.<sup>4</sup>

The outbreak of war found Latin American countries hard pressed for foreign exchange and with exchange control systems similar to those described above; the purchase of foreign bills was subject to strict license. The cutting off of European markets, which were especially important to certain countries such as Argentina, intensified the exchange difficulties and caused a piling up in Latin America of goods that were customarily exported. The situation was relieved through increased purchases by the United States in these countries, to a considerable extent governmental purchases, and as a result of loans granted them by United States governmental agencies. This relieved the shortage of foreign exchange and promoted greater stability of rates, as well as "good neighborliness."

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<sup>4</sup> In January, 1942, the Danish authorities were able to move the exchange rate between the krone and the reichsmark 8% in favor of the krone. This reflected the heavy accumulation of claims in the Danish clearing account as a result of large exports of agricultural products to Germany without offsetting imports. Although Denmark was not required to pay occupation expenses, a similar result was accomplished in that the Danish National Bank was compelled to make advances to Germany to cover these expenses.

Although the Latin American countries accumulated sizable balances in New York and London, they did not relinquish greatly their control over foreign exchange and foreign transactions. They were, however, somewhat more lenient in granting licenses for the importation of goods. When it became possible to sell exchange more freely, the scarcity of strategic and other goods in the United States, as well as the shortage of shipping, prevented the Latin American importers from obtaining the desired articles.

## CHAPTER 30

### CLEARING AGREEMENTS, QUOTAS, AND BILATERAL BALANCING

**The Multilateral Trading System.**—The conduct of trade by means of what are known as clearing agreements developed out of the breakdown of the international trading machinery during the early nineteen thirties. As discussed in the previous chapter, the accumulated maladjustments and depression disturbances which culminated in drastic declines in foreign trade, in disrupted and unstable currency relationships, foreign-exchange shortages and world-wide economic confusion generally, produced makeshift arrangements aimed to keep essential trade going and to deal with critical situations that were pressing for some kind of action. Like exchange control, clearing agreements and attempts to balance trade bilaterally, i.e., between only two countries, were expedients that soon became directed to political ends and to purposes other than those originally intended.

Under the previously existing so-called triangular or multilateral trading system, exports, with certain limitations, tended to seek the best market wherever that might be. The export trade of a country, under this system, might be almost wholly with a single country, whereas imports could be bought from a variety of countries. Brazil could export coffee principally to the United States, yet make her purchases in Europe or wherever she desired. The United States would pay for the coffee by exporting American goods to Europe. This triangular trade, as it was known, was not merely triangular but involved many countries; in fact, the entire world was tied together in a comprehensive trading equilibrium.

The actual trade of the world, prior to the war, swung in general from west to east. The United States had an export

balance with Europe, both in its merchandise trade and in its total transactions. The United States received payment for these large exports to Europe by means of imports from South America, the Far East, and the South Pacific. Europe, in turn, paid these areas by means of exports of merchandise and services, as well as by utilizing interest and dividends upon foreign investments. Great Britain, in particular, received interest and dividends upon investments in these outlying areas and in the Dominions, and was able to use these funds to pay for goods sent from there to the United States, and which thereby helped to pay for goods Great Britain received from the United States. Multilateral trade includes every part of the world within its sphere, and pre-war trade did not all move in the direction noted. Innumerable transactions were involved and the possible combinations for settlement also were innumerable.

Under this trading system, transactions conducted in all parts of the world were, to a large extent, settled or cleared by means of accounts maintained in London and New York. Institutions everywhere maintained funds in these centers, and claims were offset and balanced against each other by the transfer of funds there. This was the multilateral clearing system that developed over a long period of years, without formal organization, and that under most circumstances functioned reasonably well. An Argentine exporter of meat to London would receive pounds sterling in payment, which would be used by Argentina to pay perhaps an exporter of jute from India to Argentina, and then by India to pay for a shipment of machinery from England to India, or perhaps to pay for a shipment of wool from Australia to India, the Australian then owning the pounds. Similarly, many transactions were stated and settled in terms of dollars in New York.

This system, it will be noted, was dependent upon a stable relationship between the pound, the dollar, and other currency units. If the pound sterling was to serve as an international unit for trade and financial transactions, its relationship to other units must be reasonably secure. When the pound collapsed in September, 1931, the international clearing system which centered in London was thrown badly out of gear. Many

accounts were shifted to New York. The subsequent devaluation of the dollar, beginning in the spring of 1933, created further havoc. In view of the wide exchange fluctuations and the risks of maintaining funds abroad, the conduct of foreign trade became more hazardous and difficult.

**Clearing Agreements.**—The breakdown of the world's trading mechanism, coupled with depression and other disturbing factors, caused goods to dam up in the exporting countries, particularly in the agricultural and raw material producing countries. Exchange control which was instituted to prevent extreme depreciation, interfered with the transfer of funds and thereby with the clearing of transactions. Restrictions and moratoria upon the transfer of funds also discouraged trade, since an exporter did not wish to have his funds tied up abroad, and be unable to convert into his own money the proceeds of a transaction. Furthermore, artificially held down exchange rates tended to reduce the profits accruing to exporters from exchange control countries. An increase in exports, however, from countries where a shortage of exchange existed, would have helped to relieve the situation—an automatic remedy (although perhaps a painful one if it entailed severe exchange depreciation). Restrictions on exchange thus tended to reduce trade still further.

The disturbances in world trading arrangements and the inability to move goods, and to realize on blocked accounts, led to the seeking of new means by which trade could take place and funds be transferred. The clearing agreements which developed took various forms, but involved essentially arrangements between two countries whereby goods of one country would be exchanged for goods of the other country, the entire transaction to be settled outside the regular foreign-exchange market. According to this system, importers of goods from the other agreement country did not need to buy foreign bills, but would pay their local money into a clearing fund, probably in their own central bank. Out of this fund would be paid, also in local money, the exporters to the other country. The same procedure would be followed in the second country. In each case, the

importers, in essence, pay the exporters, so that in neither country is it necessary for the traders to buy foreign exchange. Such agreements permit trade between pairs of countries which can be settled merely by the transfer of money within each country through accounts set up for this purpose.

If the shipments arranged are of equal value, according to the terms of the agreement, the transaction is complete and no balance remains in the clearing fund in either country. However, if shipments in one direction are larger than in the other, the country with an excess of imports has a surplus in the fund paid into it by the importers, while the other country has a deficit, or balance of claims on the first country. If the country that exports more heavily and thereby builds up a balance of claims on the other country is in debt to the other country, this permits the liquidation of the debt or part thereof, provided the previous difficulty was a shortage of foreign exchange or inability to transfer funds rather than inability to raise the necessary revenue at home. Clearing agreements can thus be used to help pay off debts, or thaw "frozen credits."

Inasmuch as a large number of blocked accounts, frozen credits, or uncollectible claims of one form or another existed, there was an incentive on the part of the creditor group to promote clearing agreements with their debtor countries. In the debtor countries, clearing agreements made possible the reduction of indebtedness. In both groups clearing agreements caused goods to move and thereby relieved the pressure from the piling up of goods which otherwise could not be sold. Apart from facilitating debt collection, the agreements made possible two things: first the acquisition from abroad of materials and goods urgently desired, and second, the disposal of domestically produced goods which existed in surplus. These were usually the dominant motives behind their negotiation.

The terminology regarding clearing agreements and bilateral balancing is sometimes confusing. The terms "compensation agreements" and "payment agreements" have been used to describe special types of agreements. The word "compensation" was originally applied to agreements arranged between private parties in two countries according to which certain specific

goods would be exchanged against each other, the transaction being complete in itself. The trade was essentially barter and was also known by that name. Some of these compensation or barter transactions were complicated, and involved the giving and receiving of several kinds of commodities as well as of securities and blocked funds, the total of what was given being arranged to equal the total of what was received. These agreements were stimulated by the desire to realize on funds immobilized in some other country by exchange control. The term "compensation" was also sometimes applied to agreements between countries made for the purpose of regulating the private compensation agreements. The private deals were sometimes a means of circumventing exchange regulations and of withdrawing capital, and, therefore, invited government supervision. As the private agreements were subjected to regulations and were conducted through banking channels, they became in many instances not very different from ordinary private enterprise.

The expression "payments agreement" was used to refer to a form of clearing agreements which included not only commodities, but especially transactions involving the so-called invisible items in a country's foreign payments, such as repayment of debt, tourist travel, and services of various kinds. Thus an agreement might provide that some of the funds were to be available for these various purposes. Payments agreements developed out of and are not very different from ordinary clearing agreements.

The original private barter deals soon gave way to official clearing agreements between countries, and these agreements rapidly expanded to include a variety of transactions, tangible and intangible, in addition to simple commodity trade. For example, the Anglo-German agreement of November, 1934, usually known as a payments agreement, provided that approximately 55% of the pound proceeds realized from German exports to Great Britain could be used by German importers to buy British goods; of the remainder, part should be used to liquidate debts, which were in arrears, and part was to be available to Germany as free exchange. Payments agreements are



thus a form of clearing agreements; in fact, the two are hardly distinguishable.

One of the first payments agreements, subsequently used as a guide for others, was that signed in 1933 between Argentina and Great Britain. This agreement provided that the sterling proceeds accruing to Argentina as a result of exports to Great Britain should be used to pay, in addition to Argentine imports from Great Britain, for freight charges on British ships and for dividends and interest on Argentine securities owned by British subjects; a portion of the sterling proceeds might also be used to service obligations of the Argentine Government which were held by foreigners outside of Great Britain.

Clearing agreements, it will be noted, do not permit dispensing with a rate of exchange. Inasmuch as the participating countries have different currency units, there must be provision as to how much of one currency is equal to a given quantity of the other, unless, of course, the entire transaction were to be stated in physical quantities, which was seldom the case. In most agreements the exchange rate to be employed has been a chief point of debate and bargaining. The terms of trade can be made more favorable or less favorable by a slight alteration in the rate of exchange, so that the rate adopted is a significant matter for negotiation.

Clearing agreements were introduced in Europe in November, 1931, and spread rapidly during the subsequent few years. By 1939 there were 171 such agreements in force, embracing 39 countries. The proportion of the total trade of the world carried on under these agreements has been estimated at 12% for 1937.<sup>1</sup> Most of the agreements are bilateral, but there have been agreements centering in Berlin providing for multilateral clearing within Europe.

The war did not bring an end to clearing agreements, but on the contrary both Great Britain and Germany negotiated such agreements to assist in their war efforts. As discussed in the last chapter, Great Britain promoted clearing agreements between sterling area countries and those outside the sterling

<sup>1</sup> Cf. J. B. Condliffe, *The Reconstruction of World Trade*, W. W. Norton & Co., Inc., 1940.

area, according to which the non-sterling countries accepted payment in sterling in London for exports sent to any of the sterling countries. This arrangement made available to Great Britain the foreign exchange coming into possession of the sterling area countries, since these countries were not required to use it to pay for imports, except those from the United States, and therefore turned it over to Great Britain and accepted sterling.

Germany made clearing agreements with the occupied and other countries under German domination, whereby these countries received mark balances in Berlin for goods supplied to Germany. Germany thus developed a clearing system centering in Berlin which permitted her to obtain imports and to pay for them in her own mark currency. The rates of exchange which these countries were forced to accept greatly favored the mark. These trading arrangements based on the mark and on Berlin as the clearing center were in line with Germany's plans for post-war organization.

**Import Quotas.**—In an endeavor to avoid exchange control, which was repugnant to the financial interests in the larger European countries, a system of import quotas was developed especially in 1931, 1932, and the years following. These quotas were originally aimed primarily at keeping out the cheap agricultural products of countries whose currencies were depreciated; they also tended to limit the demand for foreign bills. Low agricultural prices had prevailed throughout the world prior to the abandonment of gold by Great Britain in 1931, but the depreciation of currencies after the collapse of the pound threatened European countries with increasingly heavy imports of agricultural products from non-European areas, and encouraged the limitation of imports by quotas.

To meet this situation, European countries established a system of quotas restricting the amounts of certain commodities that could be imported. Although there are many variations, the quota system involves: first, the establishment of the global quota; second, its allocation among the exporting countries; and third, its apportionment among the domestic importing

firms and the issuance of licenses accordingly. Many of the quotas, such as those established by France, which inaugurated quotas in May, 1931 prior to the collapse of sterling, were allocated among the principal countries from which exports came, in proportion to each country's share in the quota nation's trade during some previous unrestricted period. This same principle of allocation according to some previous base period was also often applied to importing firms. It will be noted that this procedure tends to freeze trade in existing channels and existing hands. It does not allow for the constant changes which are necessary for an efficiently functioning economy.

The quota system usually started in a small way with only a few items subject to restrictions, but ordinarily it expanded rapidly as more and more articles were added. Thus Rumania started with 120 articles in November, 1932, but by the following July had made 500 articles subject to quota. France by 1934 had placed over 3,000 articles on the quota list.<sup>2</sup> Industrial articles have been controlled by quotas, but the system applies primarily to agricultural commodities.

For a good many years the production and marketing of certain articles, such as sugar, have been restricted by international agreements, the main purpose in such instances being to hold up the price and to protect producers. Agreements have been negotiated among countries producing a certain commodity providing for export quotas for that commodity, sometimes in conjunction with import quotas for the commodity by the principal consuming country. The coffee agreement promoted by the United States between it and the Latin American coffee-producing countries, ratified in 1941, limits the amount of coffee each country is to ship to the United States, and also to the outside market.<sup>3</sup>

Commodity agreements of this type tend to stabilize prices and production, but also have their uneconomic aspects, especially in that they tend to impede the changes and adjustments

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<sup>2</sup> *Ibid.*

<sup>3</sup> Inter-American Coffee Agreement, Treaty Series 970, Government Printing Office, 1941.

in production and trade which are constantly taking place in the interests of efficient production.

Similar in character and purpose to import quotas are import surtaxes, which were levied upon imports in addition to the regular duties. During the depression, France ordered the payment of surtaxes on imports from countries with depreciated currencies; in order to offset the stimulus given imports from such countries.

The quota system did not have as its main aim the regulation of exchange rates. Adopted at first largely as a defensive measure for the purpose of restricting imports and thereby protecting domestic producers, the system came to be used as an aggressive bargaining tool for political ends, an instrument of economic warfare. Like exchange control, the purpose of which shifted from the major one of preventing depreciation of rates to the manipulation of rates so as to accomplish political and other objectives, the quota system has important consequences in altering the pattern of production and trade, tending to interfere with productive organization in harmony with comparative advantages and the free choices of consumers.

**Economic Aspects of Bilateral Balancing.**—Exchange control, licensing restrictions, quota limitations, clearing agreements, and other regulatory procedures are all intimately related, one leading to or supplementing the other. They all tend to alter or distort trade and production from the lines which would otherwise be followed. Apart from the political ends to which some of these devices have been directed and their use in economic warfare, they have far-reaching and fundamental consequences of an economic nature.

Attempts to make trade balance bilaterally, that is between one country and every other country individually, narrow the market and interfere with specialization and production according to comparative advantages. Such measures, by artificially encouraging production here and discouraging or preventing it there, run counter to production by the most efficient. They tend, therefore, to contract total output and to reduce the standard of living. By altering the amounts produced of certain

goods, encouraging this particular good and discouraging that good, they prevent production from being of a type in harmony with the free choices of consumers. Restrictions which prevent certain goods from being imported, or which determine that the goods shall be bought in this country rather than that country, cause production to expand or contract according to artificial standards, rather than according to those determined by efficiency and the desires of consumers. This was evident when some of the countries which made agreements with Germany discovered that they must accept unwanted quantities of harmonicas, typewriters, out-of-date armament, or aspirin—although the agreements may have improved the market for the latter two items.

Bilateral balancing thus forces trade into uneconomic channels. It interferes with the system of multilateral balancing which binds together the entire world structure of trade, production, prices, investment, and financial and economic relations generally. A break in any link in this interrelated system leads to a series of disturbing consequences.

Bilateral balancing is damaging to outside countries, since purchases that would otherwise take place there are reduced or diverted to an agreement country, probably an uneconomic diversion. League of Nations' statistics have shown this diversion to exist. For example, German trade with her clearing agreement countries expanded considerably in the last quarter of 1934 compared to that of 1933, but declined with those countries with which Germany did not have agreements. Furthermore, in outside countries prices of certain commodities are depressed, commodities whose markets are interfered with by the clearing agreements. Goods acquired by Germany under clearing agreements have at times been dumped on other countries at low prices, to the detriment of countries producing such goods, particularly the clearing agreement country which supplied them.

If a creditor nation is to receive payment from a debtor nation via clearing agreements, the creditor nation must have an import balance in the clearing account from the debtor nation. If the trade, however, does not create such a balance, no debts can be repaid. Clearing agreements may encourage debtor coun-

tries that are short of foreign exchange to buy even more from their creditors, since no exchange problem then exists. If the debts are to be repaid, however, debtor countries should buy relatively less, or should export more.

Clearing agreements are frequently evaded by exporters, particularly in countries with rigid exchange restrictions and moratoria on the transfer of funds, and where the official exchange rate is low. An exporter may keep abroad a portion of the proceeds of his sale rather than have the full price paid to him from the local office in local money and at a low rate. He may do this through a supplementary arrangement with the foreign importer, made quietly on the side. The prices appearing on the face of the transaction may thus be fictitious.

Of the advantages claimed for clearing agreements few appear to have much real merit. During a period of economic stagnation and depression, clearing agreements undoubtedly made possible a certain amount of trade that would otherwise have not taken place, and that was profitable to both parties. They permitted surplus goods to be exported, and shortages of certain materials to be relieved. Furthermore, clearing agreements facilitated the liquidation of a large amount of frozen claims. They also emphasized, what legislators have commonly failed to grasp, that imports and exports pay for each other, and that debt must be paid in goods and services.<sup>4</sup>

Apart from their use as weapons of economic warfare, clearing agreements and other artificial restrictions and measures directed toward bilateral balancing are essentially substitutes for what under most circumstances is a more economic and advantageous method of conducting trade. It is possible, however, that in proper hands clearing agreements can in certain instances be made to serve desirable ends.

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<sup>4</sup> For a favorable discussion of clearing agreements see Paul Einzig, *The Exchange Clearing System*. On the other hand, see the League of Nations *Enquiry into Clearing Agreements* (1935).

## CHAPTER 31

### INTERNATIONAL ECONOMIC COOPERATION

Events during the inter-war period illustrated too clearly the difficulties that come from lack of cooperation among nations in economic and financial matters, as well as in political matters. The second World War has emphasized the basic interdependence of nations and regions, and has strengthened demands that nations find ways of interlocking their economic systems so that they will function to better advantage than has been the case in the past.

The physical potentialities of the world's production of goods and services are enormous, if nations can devise procedures which permit reasonably complete and efficient utilization of resources, labor supply, and technological knowledge. Among the obstacles to fuller production have been the innumerable political barriers of a nationalistic sort, and the lack of cooperation in dealing with economic forces which are international in cause and effect. Forces which have to do with such things as prosperity and depression, with economic equilibrium at a high level of activity, are world-wide in scope. How far nations are able and willing to go in surrendering certain sovereign rights in the interests of a more adequately functioning economic order remains to be seen. The principle, however, is not new, since every treaty or binding international agreement is to a greater or less degree a surrender of sovereign rights.

Efforts toward international economic cooperation go back for many years, but the first World War gave impetus to concerted moves in this direction. A chief weakness and reason for the inconclusive results of the many attempts during this period was an unwillingness to surrender the necessary sovereign rights, and therefore a lack of authority to enforce multilaterally such measures or procedures as were agreed upon

in principle by the "experts." Nationalistic thinking dominated most statesmen and their publics; and the loose and weak cooperation that was undertaken was entirely inadequate.

Among the various international organizations which came into being after the first World War, and whose objectives were to deal cooperatively with economic and other questions, was, first, the League of Nations itself. The economic activities of the League and its committees, including the work of the Economic and Intelligence Service, gained the confidence and respect of economic students everywhere, and marked a new stage in international economic relations. This work was carried on under most difficult circumstances. It was not allowed to lapse with the outbreak of war in September, 1939, much of the work being continued from League offices in Princeton, New Jersey.

The International Labor Office is an autonomous organ of the League of Nations. The work of this organization in the field of labor, particularly in developing standards for labor legislation, is noteworthy. During the war the activities of the International Labor Office are being carried on from Canada.

Other international agencies, both governmental and private, concerned with economic matters include the Bank for International Settlements (discussed below), the International Institute of Agriculture, the International Institute of Intellectual Cooperation, the International Red Cross, the International Chamber of Commerce, the Pan American Union, the Permanent Court of International Justice, and various other organizations.

Economic cooperation in the western hemisphere has made considerable progress, and is discussed in Chapter 34.

**International Economic Conferences.**—During the nineteen twenties and thirties several attempts at economic collaboration were made through the medium of international conferences.

In 1920 when currencies and exchange rates were extremely disturbed throughout all Europe, a financial conference was held in Brussels. Financial conditions in Europe were chaotic and



governments were pursuing uneconomic and often contradictory policies. Currency inflation was rampant, prices were rising rapidly, government debts were still growing, and national antagonisms and suspicions were keen. The conference met in the midst of this to do what it could to help reconstruct financial systems. It adopted several resolutions urging the removal of the impediments to trade, abandonment of the artificial limitations upon exchange operations which were so damaging to trade, and the reestablishment of the gold standard. These declarations had a wholesome influence, but resulted in little concrete action.

Two years later, in 1922, another conference assembled in Genoa, Italy, to carry on the work begun in Brussels. The Genoa conference dealt especially with the question of currency stabilization, a most urgent problem at that time. It recommended that all European currencies be based upon the gold standard. It declared against financing budgetary deficits by paper money issues, which was still the procedure in several countries, and declared that currency stability was a first requirement for economic equilibrium. The vital questions of reparations and war debts, however, were ruled out, because feelings regarding them were too strong to permit their impartial consideration.

The so-called Dawes Conference met in Paris early in 1924 for the purpose of reaching some working arrangement on the troublesome question of reparations. The amounts demanded of Germany by the Allies were far in excess of Germany's ability to pay. Attempts to collect from Germany, and German attempts to pay the sums demanded, were in large measure responsible for the extremely disturbed economic conditions prevailing throughout most of Europe. Inflation in Germany had reached the point where trade and the conduct of ordinary business had practically collapsed.

The Dawes Conference, called by the Reparation Commission of the allied powers, met at a critical time when some sort of a workable financial arrangement was imperative. The conference established what sums it thought Germany could reasonably be expected to pay during the next few years, purposely

leaving the total amount of the reparation bill indefinite so as to bring agreement. Plans were prepared regarding various measures for the financial and economic reconstruction of Germany, including stabilization of the currency. The recommendations of the conference were promptly put into force with successful results. The conference marked a turning point in post-war European economic affairs, away from chaos toward an ordered, although still disturbed, economy. The record of accomplishment of many international conferences is not particularly significant, but such was not the case with the Dawes Reparation Conference, partly because of the urgent necessity of doing something. The reparation question is discussed in Chapter 36.

The first so-called World Economic Conference assembled in Geneva in 1927 under the sponsorship of the League of Nations. This conference, to which the United States sent delegates even though this country was not a member of the League, concerned itself particularly with the question of trade barriers. Nearly 50 nations were represented at the conference by some 200 delegates, consisting of leading business men, bankers, economists, and statesmen. All over the world the tendency of nations had been to raise tariff and other barriers continually higher. Most of the newer nations, brought into existence since the war, were turning toward economic nationalism, and had aims of increasing their self-sufficiency by the shutting out of many foreign goods. The conference declared very definitely against trade barriers, pointing out the interdependency of nations. It urged the immediate reduction, by successive stages, of the barriers which so gravely hampered trade. In spite of these declarations, the nations of the world, with the United States in the forefront, continued to march on toward higher and higher tariffs and other forms of restriction.

The second World Economic Conference met at a time when the world depression was getting under way, in 1930. This conference accomplished very little of a constructive nature.

The Dawes Plan regarding reparations had involved only a temporary settlement, since this was all that could be accomplished at that time. By 1929, Germany, irking under the payments, was anxious to have amounts scaled down and to have

matters settled permanently. A second reparation conference was accordingly held, in 1929, this time under the chairmanship of another American, Owen D. Young. As a result of this conference the amounts to be paid were substantially reduced. With the depression which followed almost immediately, came the 1931 moratorium of war debts and reparations, on the initiative of President Hoover, so that payments under the Young Plan were short-lived. After the expiration of the moratorium, no further payments were made. Another conference on reparations was held at Lausanne in 1932, and provided for a final payment by Germany, contingent upon a "satisfactory settlement" of the war debt question by the United States. No payments, however, were made.

As the world depression increased in its severity, and as currency disorders spread following the departure of Great Britain from gold in September, 1931, renewed realization of the intimate economic and financial relationships among nations led to discussions regarding the holding of another world economic conference. Accordingly, the Monetary and Economic Conference convened in London in June, 1933 with high hopes, and with 66 nations participating.

It was generally expected that the conference would deal especially with the pressing question of currency and exchange stabilization. Commodity prices all over the world had been suffering drastic declines, with the consequent upheaval of economic systems and a great amount of resulting distress.

The United States was expected to help lead the way toward financial reconstruction and stabilization. The Roosevelt Administration in the United States, however, was at the beginning of its price-raising policy aimed to further recovery. This country's currency ideas, moreover, were not yet fully formulated. The policy of raising the domestic price level in the United States, depreciating the dollar, was of course inconsistent with stabilization of exchange rates between dollars and other currencies. The United States was, therefore, unable to cooperate in the program of international currency stabilization. When the conference was informed of the position of the United States, a great deal of ill-will was heaped upon this country, and

the conference soon broke up having accomplished almost nothing.

The conference, however, took significant action with respect to silver. Under the sponsorship of American silver interests, a resolution, introduced by the United States delegation, was approved unanimously by the delegates of the 66 nations. It recommended that nations using, producing, or holding silver make an agreement with a view to mitigating the fluctuations in the price of the metal; that the nations refrain from further debasement of silver coinage; and that they substitute silver for low value paper currency. The agreement referred to was signed outside the conference by eight nations. It provided, among other things, that India limit its annual sales of silver, and that other nations withdraw from the market annually a certain amount of their mine production.

The silver agreement was thought of generally as one looking toward stabilization of the price of silver, which meant prevention of the sharp declines which had been taking place. However, the United States' silver policy became one of aggressive buying of the metal for the purpose of raising its price. The effects upon China of the rise in the price of silver were profound, and forced China to abandon that country's historic silver standard.

**League of Nations' Rehabilitation of Austria.**—A significant instance of international collaboration and action along financial lines was the rehabilitation of Austria by the League of Nations. After the first World War, when Austria was proclaimed a republic, the country was in critical circumstances. Inflation was serious, the food supply inadequate, and the country practically bankrupt. It had been divested of much of its vital territory by the peace settlement.

The matter of Austria's critical status was taken up at the Brussels conference in 1920. Credits were granted the country by the different European nations and by the United States, so that conditions were relieved, but only temporarily. Conditions in Austria continued grave, and in 1922 Austria appealed to the Allied nations for further aid. The matter was referred to the

League of Nations, which thereupon undertook the reconstruction of Austria.<sup>1</sup>

Under League auspices finances were reorganized, the currency stabilized, a national bank established out of the Austrian section of the former Austro-Hungarian Bank, and many other economic measures adopted. An international loan was negotiated, different portions of the loan being guaranteed by the following countries: Great Britain, France, Czechoslovakia, Italy, Belgium, Sweden, Holland, and Denmark, the first four countries being responsible for the largest portions. Austria was thus enabled to become a going concern, although the country continued to be faced with many serious troubles, political and economic. Its absorption by Germany in March, 1938, solved some of the economic problems, but added new troubles of another sort, marking the beginning of German aggression on neighboring countries.

**Monetary Unions.**—The first significant cooperative currency arrangement in modern times was in 1865 when the so-called Latin Monetary Union was formed. This grew out of the currency difficulties following the fall in the value of gold after the California gold discoveries of 1849 and 1850. As a result of the cheapening of gold, or rise in the price of silver, Switzerland reduced the amount of silver in her subsidiary coins. These then began to be substituted in the neighboring countries where Swiss coins were current for the full weight coins of these other states, notably of France. In order to remedy the difficulties and to facilitate trade and financial dealings, a treaty was negotiated between France, Belgium, Switzerland, and Italy, the aim being to establish in these nations uniform coinage on a bimetallic basis.<sup>2</sup>

The agreement provided for the minting by the different nations of coins of similar weights and finenesses, involving the same ratio, 15½ to 1, between gold and silver. The size and general appearance of the coins were identical in all four of

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<sup>1</sup> The League subsequently undertook the reconstruction of Hungary, which was also accomplished successfully.

<sup>2</sup> Spain and Greece participated in the negotiations but never put the agreement into force.

the countries, although their insignia differed. The coins of the four nations parties to the agreement were accepted in any of these countries, circulating across national boundaries.

Soon after the monetary union was launched, the price of silver began to decline in terms of gold. Large amounts of silver were then presented for coining into 5-franc pieces at the mints of these countries. As a result, the countries were afraid that they might be forced onto the silver standard, and therefore by agreement limited the amount of silver which each could coin. The price of silver continued downward, and in 1878 the coinage of silver 5-franc pieces was completely suspended. Although the Latin Monetary Union continued in nominal existence, the countries all shifted to the gold standard, and the agreement became a dead letter.

The Scandinavian Monetary Union was formed between Denmark, Norway, and Sweden, and according to the treaties of 1873 and 1875 gold and silver coins of any of these three countries were lawful money in all of them. The currency system was the gold standard, and silver money was coined only on government account, its supply thus being limited. Silver coins were legal tender only up to certain amounts. The bank notes of the three Scandinavian central banks were also accepted at par in all three countries. The central banks held balances for one another and sold drafts against these balances, usually at par. In this manner the central banks kept exchange rates practically at par.

The Scandinavian Monetary Union continued successfully until during the first World War period. When the currencies of Norway and Denmark became depreciated in Sweden and when gold shipments were interfered with, silver coins were sent to Sweden to establish balances there. Large quantities of the fiduciary silver coins thus appeared in Sweden. The traffic was stopped, and Norway and Denmark bought back their silver at considerable expense. In 1924, Sweden declared the money of Norway and Denmark no longer valid in Sweden.

In September, 1936, when France devalued the franc, the United States, Great Britain, and France announced that they had concluded an agreement, which became known as the Tri-

partite Currency Agreement, according to which these nations agreed to cooperate in the stabilization of their currencies. Other nations were invited to participate, and Switzerland, the Netherlands, and Belgium soon joined in the accord.<sup>3</sup>

Soon after this agreement, or declaration, was made public, the United States announced it had entered into an arrangement with Great Britain and France for the purchase and sale of gold through the stabilization funds of the respective countries, for the purpose of reducing the fluctuations between their currencies (October, 1936). Gold imports and exports into or from the United States were to be undertaken by the government, and private licenses to export gold were to be practically abolished. Gold was to be exported only to nations parties to the agreement.<sup>4</sup>

In June, 1937, France suffered severe losses of gold, with the result that France was forced to permit the franc to decline; on July 1 the previous legal limits to exchange fluctuations were removed. In the mind of the public in the different countries, the question was raised as to whether the Tripartite Currency

<sup>3</sup> The announcement of the United States Treasury said in part:

"1. The Government of the United States, after consultation with the British Government and the French Government, joins with them in affirming a common desire to foster those conditions which safeguard peace and will best contribute to the restoration of order in international economic relations. . . .

"2. The Government of the United States must, of course, . . . take into full account the requirements of internal prosperity, . . . it welcomes this opportunity to reaffirm its purpose . . . to maintain the greatest possible equilibrium in the system of international exchange and to avoid to the utmost extent the creation of any disturbance of that system by American monetary action.

"3. . . . The United States Government, as also the British and French Governments, declares its intention to continue to use appropriate available resources so as to avoid as far as possible any disturbance of the basis of international exchange resulting from the proposed (French) readjustment.

"4. The Government of the United States . . . attaches the greatest importance to action being taken without delay to relax progressively the present system of quotas and exchange controls with a view to their abolition.

"5. The Government of the United States, in common with the Governments of France and Great Britain, desires and invites the cooperation of the other nations to realize the policy laid down in the present declaration. It trusts that no country will attempt to obtain an unreasonable competitive exchange advantage and thereby hamper the effort to restore more stable economic relations which it is the aim of the three Governments to promote." *Federal Reserve Bulletin*, October, 1936.

<sup>4</sup> The Secretary of the Treasury in his announcement said that the United States would "sell gold for immediate export to, or earmark for the account of, the exchange equalization or stabilization funds of those countries whose funds likewise are offering to sell gold to the United States, provided such offerings of gold are at such rates and upon such terms and conditions as the Secretary may deem most advantageous to the public interest." *Federal Reserve Bulletin*, August, 1937.

Agreement was still in force. The matter was promptly settled by an exchange of communications on July 1, between the Treasuries of the three countries. Secretary Morgenthau addressed the following message to the French Minister of Finance, and a similar message was sent by Great Britain: ". . . I look forward to a continuation of close cooperation between our Treasuries under the Tripartite Declaration."

After the outbreak of war in September, 1939, Secretary Morgenthau issued a statement to the effect that the agreement was still in force. With the occupation of France and the other countries by Germany, however, the agreement became a dead letter. The agreement and accompanying arrangements, nevertheless, marked a change in the currency philosophy of the United States. It involved recognition of the international nature of the currency problem and was a move toward joint action in this field. The agreement contained a plea for less interference with trade and foreign-exchange dealings, so as to provide a background more conducive to currency stability. It was a declaration of purpose and intent rather than a binding contract, and was voidable at any time; this made it more acceptable to the American public. While the agreement was a step forward, it was merely a beginning. Financial and economic measures to be instituted in the post-war period must go much farther in the direction of cooperation, if these problems are to be dealt with satisfactorily.

**Bank for International Settlements.**—The report of the Young Committee on Reparations in 1929, recognizing the need for central bank cooperation, arranged for the establishment of the Bank for International Settlements. The Bank, a joint undertaking sponsored by the leading nations, was promptly organized with headquarters in Basel, Switzerland. The stock of the Bank was subscribed for by the central banks of 26 leading nations. The United States Government would not permit the Federal Reserve Banks to purchase stock, so the amount allotted to this country was bought by private American banks. The Bank of Japan also did not participate in stock ownership because, it was said, of the distance from Tokio to



Basel. The stock allotted to Japan was accordingly held by a group of Japanese bankers. Each of the seven founder countries, Belgium, France, Germany, Great Britain, Italy, Japan, and the United States, were allotted 8% of the 200 shares of stock.<sup>5</sup>

The Board of Directors consists of 25 members made up as follows: (1) the governors of the five central banks mentioned above, together with a Japanese and an American selected by these five governors; (2) one business man from each of the above seven countries; (3) nine persons representing member banks of participating countries. Group (1) above selects group (2) and they together select group (3). The first two presidents of the Bank were Americans; the third was the former head of the Netherlands central bank. The Bank is not allowed to issue circulating notes, and its operations in any country are subject to approval of the central bank of that country.

Much of the work of the Bank during its early existence was expected to be the receipt and disbursement of reparations. This was the case, but in 1931 reparation payments were suspended. Furthermore, the Bank had scarcely begun operations when widespread depression seized the world. Although the activities of the Bank were not as extensive as was expected, and while the Bank did not develop along the lines anticipated, due to the cessation of reparations, the international economic disturbances and finally the war, the Bank has served a useful purpose. The periodic meetings of the governors of the different central banks, as directors of the world Bank, provided a means of getting these men together regularly and without publicity, resulting in informal cooperation which was greatly needed. The Bank eliminated some of the gold movements by offsetting book entries. It made advances to banks in various parts of the world for the purpose of stabilizing conditions and preventing financial troubles. It loaned considerable sums to the German Reichsbank in 1930 and 1931. It also aided Austria in 1931. The statistical services of the Bank were also very valuable.

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<sup>5</sup> Some of the stock was sold by the central banks of France and Belgium to the public, although these banks retained their voting rights.

Most of the Bank's day-to-day work had to do with devising principles and techniques for central bank cooperation.

In spite of the war the Bank has continued to operate, although its activities are greatly restricted. Even before the war the Bank was dominated by Germany, and after the outbreak of war formal control passed to Germany.

In view of the unprecedented disturbances throughout the world, currency and exchange difficulties, political instability, and then war, the growth and development of the Bank has been seriously handicapped. The need for an institution of this type, however, is great, and the Bank, revised, or another institution which supplants it, may have an important future.

## CHAPTER 32

### AMERICAN MARITIME POLICY

**The American Merchant Marine Prior to 1914.**—The history of the American merchant marine is a story of successes and reverses, of rapid rises and equally rapid declines. During the Napoleonic wars in the early part of this country's history, the United States expanded its shipping rapidly, as discussed in Chapter 3. The dominant position which this country came to occupy in shipping during this early period was not merely because European nations were otherwise engaged, but also because of natural advantages. With the depression and dullness in foreign trade after these wars, American shipping suffered.

Nevertheless, until the Civil War, the United States was a shipping nation of the first rank. The first vessel built in America was the *Virginia*, launched in 1607 in the Kennebec River in what is now Maine. Yankee clipper ships soon came to be famous for their speed and grace, and were a familiar sight in ports all over the world. They were so fast that they received special freight premiums by shippers of other nations.

A number of reasons accounted for American preeminence in shipping during these early years. In the first place, the North Atlantic coast contained large supplies of excellent timber and other materials for shipbuilding purposes, placing the United States in a position of comparative advantage in an era of wooden ships. The North Atlantic region, moreover, was not well suited to agriculture, as were the lands farther south and west. The early settlers, also, were dependent upon water transportation, and many localities had no other means of communication. Furthermore, shipbuilding in America had the advantage of an early start, many of the newcomers from England and elsewhere being skilled in the shipbuilding trade. Thus shipping and shipbuilding offered about as high returns as could be secured in any field in this country. The abundant in-

vestment opportunities, which were later to be so characteristic of American industry, had not as yet emerged.

The Civil War put an abrupt end to the prominent position of America in world shipping. Although it appeared that the destruction and demoralization produced by Confederate preying on vessels was the most important cause for the decline, the real causes ran deeper. In the first place, the era of wooden ships was over. The substitution of iron for wood took place rapidly during the sixties and seventies, and in the building of iron vessels, American costs were much greater than those in Great Britain. Furthermore, sailing vessels gave way to steamships, which development also damaged America's position in shipping. Between 1860 and 1870, British merchant tonnage increased from 5,710,000 to 7,150,000. Of this latter figure, 1,113,000 tons were propelled by steam.

Important also in the decline of America's shipping was the fact that the rapid industrial development of the United States which followed the Civil War, including completion of trans-continental railroad systems, offered richer returns for the investor than could be obtained from ocean shipping. In other words, America had lost most of its comparative advantages as a shipbuilding and shipping nation.

The extent of the decline was great. Whereas in 1830, 90% of American foreign trade was transported in American vessels, only 35% was thus carried in 1870, and only 9% in 1900. In the 50 years of unparalleled industrial expansion from 1860 to 1910, American shipping tonnage engaged in foreign trade not only failed to increase, but dropped from 2,300,000 tons to 783,000 tons.

**The American Merchant Marine During the First World War.**—The first World War, like the Civil War, marked a sharp change in the fortunes of the American merchant marine, but in an opposite direction. The beginning of the war found the United States with practically no merchant marine, while ten years later this country possessed a substantial fleet of ships. When the war commenced, European nations called home their ships and used them for war purposes, with the result that

American goods were suddenly left inadequately provided for. Freight piled up on the docks. The United States clearly realized that it needed a merchant marine.

In 1916, the United States, still a neutral nation, passed a law providing for the formation of the United States Shipping Board. This agency was created principally for the purpose of developing a large American merchant marine and naval auxiliary. It was also given power to regulate American waterborne commerce. With the entry of the United States into the war in the spring of 1917, the Shipping Board created the Emergency Fleet Corporation (later called the Merchant Fleet Corporation), with a capital of \$50,000,000. All stock in this organization was owned by the government, with the exception of a small number of shares held by the trustees to enable them to qualify for their posts.

The Emergency Fleet Corporation undertook a huge program of ship construction. Between 1917 and 1922, the United States launched 2,316 hulls. Most of these were built at the Hog Island shipyard near Philadelphia. When the United States entered the war, Hog Island was merely a swamp on the Delaware River. Work was commenced in September, 1917, and a year later Hog Island had 30,000 workers, 250 buildings, eighteen miles of road, and 80 miles of railroad track. Its first ship was then afloat, being outfitted for service. The government thus went wholeheartedly and expensively into the business of building and operating ships.

As a result of intensive construction, the Emergency Fleet Corporation in a period of two or three years transformed the American merchant marine into one of the largest in the world. But the ships were not available in time to be of much help during the war. The United States was dependent upon ships of the Allied nations for the transportation to France of its men and supplies.

In 1917, the United States seized the German ships that had been tied up in New York when hostilities began. The largest and most spectacular of these was the *Vaterland*, only four years old, and the largest ship afloat. The German crew had endeavored to make the ship unusable by damaging her

engines, throwing vital parts overboard, and destroying blueprints. However, within a few months the boat, renamed the *Leviathan*, was en route to Europe with some 10,000 American troops. After the war, the vessel was reconditioned by the Shipping Board at a cost of about \$10,000,000 and became a luxurious passenger liner. Later, she passed into the hands of the United States Lines, and lost this company large sums of money. In 1934 the ship was tied up, unable to compete with more modern rivals, and in 1938 proceeded to Great Britain under her own power to be broken up for scrap.

In 1920 the government, through the Shipping Board, owned 1,491 vessels with a total tonnage of 9,200,000 dead-weight tons. These were principally freight vessels, tankers, and refrigerator ships, although some were cargo-passenger ships.

**The American Merchant Marine after the First World War.**—From shortly after the first World War until about 1937 the American merchant marine continuously deteriorated. When the war was over, the Shipping Board followed the policy of selling to private companies the vessels under its control, the aim being to foster a privately owned American merchant marine. By 1932, the Shipping Board's fleet had been reduced to 361 vessels of 3,087,000 dead-weight tons. Part of this government-owned tonnage was operated by private companies under government control, but a large portion remained idle.<sup>1</sup> The shipping business had suffered from the decline in foreign trade, and in 1937 some 162 government-owned vessels were anchored at Norfolk, Staten Island, New Orleans, and other ports. Many of these idle vessels were obsolete and in a very run-down condition. By October, 1940, largely as a result of transfers to foreign registry, the government-owned laid-up fleet had declined to 63 vessels. Most of these 63 ships were of slight commercial value, but were nevertheless later put into active service for war purposes and proved very useful.

<sup>1</sup> Most of these companies operated freight vessels. The most prominent of them, the United States Lines Company of Nevada, operated a fleet of government-owned passenger vessels in the transatlantic trade. Among the ships operated by this company was the famous *Leviathan*, long featured as "the world's largest ship," but removed from service in 1934. A vessel of smaller and more economical type, the *America*, was designed in 1937 to take its place, and was placed in service, along with other new vessels, shortly before the outbreak of war.

A large number of the hastily constructed wartime ships were broken up and sold for scrap in the years following the first World War. As a result of the extensive scrapping of vessels, American merchant tonnage declined rapidly from its peak reached shortly after the war. Whereas in 1921, more than 11,000,000 tons of American ships were engaged in foreign trade, in 1936 this had declined to only 3,250,000 tons.<sup>2</sup> Gross tonnage under the American flag reached its peak of 14,600,000 in 1923. The following table shows the gross tonnage of the principal nations prior to the outbreak of war in 1939.

TABLE 17. WORLD SHIPPING, JUNE 30, 1939

	Gross tons
United Kingdom .....	17,891,000
British Dominions, Colonies, etc. ....	2,966,000
United States .....	8,135,000
Japan .....	5,630,000
Norway .....	4,834,000
Germany .....	4,483,000
Italy .....	3,425,000
Netherlands .....	2,969,000
France .....	2,934,000
Greece .....	1,780,000
Sweden .....	1,577,000
Denmark .....	1,175,000
U.S.S.R. ....	1,306,000
Latin America .....	2,018,000
Other parts of the World.....	4,160,000
World .....	65,283,000

(Source: League of Nations, World Economic Survey 1939-41, Geneva, 1941)

<sup>2</sup> In 1937, there were 3,475 ships documented under the American flag, with a gross tonnage aggregating 12,475,000 tons. These ships were approximately one-tenth of all the vessels in the world and about one-fifth of the tonnage. These figures, however, need explanation. Of these 3,475 ships, 2,031 were lake boats, dredges, and non-ocean-going vessels, with a tonnage of 4,014,000. This left America with 1,444 sea-going vessels (of 2,000 tons and over), aggregating 8,461,000 tons. Of these 1,444 sea-going vessels, only about 400 were engaged in foreign trade. Approximately 200 were in lay-up, and 800 (including 300 tankers) were engaged in coastwise trade. Of these American ships many were of a specialized nature, such as tankers, designed for one type of cargo. Some were ore ships, such as those of the Bethlehem Steel's ore steamship company, which went to Chile. Subtracting the tanker fleet left America with 374 vessels, aggregating 2,311,000 gross tons, engaged in carrying dry cargo between the United States and foreign ports (June, 1937). These figures are from the study of the Maritime Commission noted. The Bureau of Marine Inspection and Navigation showed the American Marine as consisting of 26,588 vessels aggregating 14,676,128 gross tons (June 30, 1937). This, however, included everything over 5 net tons. *Economic Survey of the American Merchant Marine*, United States Maritime Commission, 1937.

The proportion of America's foreign trade carried in American vessels increased from about 10% in 1910 to 43% in 1920, but by 1930 had fallen to 35%. It had fallen to 23% when the war began in 1939, but increased thereafter. If we eliminate tankers and other specialized ships, and consider only the ocean-going dry cargo trade, the amount of this trade carried in American vessels was still less.

The relative position of the United States among shipping nations likewise declined in the years following 1920; especially since the United States merchant marine had been rapidly becoming obsolete. If twenty years be considered the normal useful life of a vessel, about 90% of the 1938 merchant marine was within two or three years of the scrap heap. When the war began, 49% of United States tonnage exceeded 20 years of age. On the basis of ships less than ten years old, the United States ranked eighth. On the basis of ships that could make twelve knots or better, the United States was fifth. The advantages which the first World War gave the American merchant marine were thus to a large extent allowed to lapse.

In spite of the deterioration in the country's shipping during the twenties and first part of the thirties, the second World War found the United States better prepared with respect to its merchant marine than in 1914. The United States ocean-going merchant marine on June 30, 1939 totaled 1,398 vessels of 8,135,000 gross tons. Of these, 319 ships of 2,094,000 gross tons were engaged in foreign trade, 132 being in the transatlantic trade. The laid-up fleet consisted of 306 ships of 1,750,000 tons. During the first eighteen months of the war, 430 ships of all types, 1,478,000 gross tons, were transferred to foreign registry or ownership. Britain received 182 of these ships of 648,000 tons, while 12 Latin American countries took 136 ships of 510,000 tons. Most of these vessels were privately owned and were sold by their owners who grasped the opportunity of disposing of obsolete ships at good prices.

The new construction program, inaugurated by the Maritime Commission in October, 1937, was speeded up as a result of the war, especially after the United States entered the war. This is discussed below.



**Merchant Marine Act of 1936 and America's New Shipping Program.**—In order to rehabilitate America's declining merchant marine, an act was passed by Congress in June, 1936, providing for the radical reorganization of the country's merchant marine. According to the "declaration of policy of the act."

It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine (a) sufficient to carry its domestic water-borne commerce and a substantial portion of the water-borne export and import foreign commerce of the United States and to provide shipping service on all routes essential for maintaining the flow of such domestic and foreign water-borne commerce at all times, (b) capable of serving as a naval and military auxiliary in time of war or national emergency, (c) owned and operated under the United States flag by citizens of the United States in so far as may be practicable, and (d) composed of the best-equipped, safest, and most suitable types of vessels, constructed in the United States, and manned with a trained and efficient citizen personnel. It is hereby declared to be the policy of the United States to foster the development and encourage the maintenance of such a merchant marine.

To realize these objectives, the act provided for a system of subsidies both for the construction and the operation of merchant vessels. According to the act, the government, after approving the building of a ship, will pay up to a certain percentage of the total cost, the difference between the cost of constructing the vessel in an American and in a foreign shipyard. The government may lend most of the remaining cost of building the ship. The government also will subsidize the operation of ships, paying ship owners the difference in cost between operating, under similar conditions, American ships and foreign ships. The act provided that vessels receiving such financial aid were to be automatically available for national defense.

The act repealed both the loan and the mail-contract provisions of the Acts of 1920 and 1928. Formerly, high rates were paid for carrying very small amounts of foreign mail. Foreign mail is now paid for at regular poundage rates. The act also provided for a system of direct grants of money.

An independent government agency, the United States Maritime Commission, was created by the act and given broad powers. The Maritime Commission consists of five members, and took over the functions of the United States Shipping Board and Merchant Fleet Corporation, which were dissolved. Most of the Commission's time during its first year was occupied in conducting studies into various phases of the American shipping problem. During this period, designs were worked out for several types of cargo and combination passenger-and-freight vessels. In the preparation of these designs, much attention was given to the safety, economy, and efficiency of the vessel, and to recent developments in the art of ship construction. By standardizing certain vessel parts, such as the hull, substantial economies in shipbuilding were achieved.

The Maritime Commission decided against the construction by America of large "super-liners," such as were featured by European lines, believing that aircraft could more satisfactorily and economically take care of rapid ocean crossings. According to the Commission, "the American contribution to North Atlantic travel should be fireproof, vibrationless, attractive, and economical vessels of reasonable size and speed, distinguished by the utmost in safety and comfort, suitable for business or pleasure travel, available for national defense, and manned by competent, resourceful, and disciplined personnel."<sup>3</sup> The first vessel contracted for by the Commission was a medium-sized passenger liner to replace the obsolete *Leviathan*, and was named the *America*. The war interfered with its operation in the North Atlantic trade, as contemplated, but the ship was very useful to the United States after this country entered the war.

The new program was slow in getting under way, and on January 3, 1938, the Maritime Commission was able to report only one contract signed for construction of new merchant tonnage. By the end of 1938, however, 52 ships were under construction. The Maritime Commission adopted a policy of contracting for the construction of 50 vessels per year. In August, 1939, however, when war was imminent, this program was

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<sup>3</sup> *Economic Survey of the American Merchant Marine*, United States Maritime Commission, 1937, pp. 22-23.

accelerated. As the defense program and lend-lease assistance got under way, and then after the United States entered the war, ship construction was greatly speeded up. By October, 1941, 112 vessels had been constructed at a cost of \$298,093,000, and 771 more, to cost \$1,751,000,000, were under construction. The goal of 8,000,000 tons was set for 1942, and 16,000,000 tons for 1943, a total of 24,000,000 tons consisting of 2,100 vessels. In 1941 new construction totaled 1,100,000 tons, and for the year ending October 1, 1942, 488 ships of 5,450,000 tons.

In view of the urgent need for ships, yards for constructing ships had to be greatly expanded. This came at a time when the largest naval building program ever undertaken by the United States was under way. Standardized design and mass production methods expedited construction. The so-called "Liberty" ship, the principal type, was 427 feet long and of 10,500 tons. Shipyards worked seven days a week, 24 hours a day.

In February, 1942, the War Shipping Administration was created, under the Office for Emergency Management, for the purpose of operating the United States merchant fleet most effectively for war purposes. It requisitioned the country's merchant marine and took charge of the allocation of cargo space. The war thus thrust the government actively into the building and operation of ships.

**Government Aid to Shipping.**—The United States apparently is not well suited to shipping, that is, the country is not in a position of comparative advantage regarding the building or operating of ships. The situation, however, is not entirely clear because of the subsidies granted shipping by most countries. Labor costs constitute a large part of the expense of shipbuilding and ship operation, and labor costs are high in the United States. The new mass production methods, however, may alter matters, and improve the relative position of the United States. Prior to the war foreign costs were very much less than those in the United States. For example, according to the construction contract for the *America*, the cost was to be \$15,700,000, whereas the Maritime Commission estimated that a comparable vessel built in the Netherlands would cost only \$10,500,000.

If the United States is permanently to have a large merchant fleet, government assistance appears necessary. American shipping companies have been chronically in financial difficulties; foreign companies have also not been very profitable.

During the fifteen-year period from 1920 through 1934, the most prosperous years for American shipping companies were 1928 and 1929. Yet in these two years only about 62% of all active companies reported any net profits. During this period, for every dollar of net income, after taxes, of the successful companies, there were 82 cents of deficits of the unprofitable companies. These figures include river and lake shipping. During 1936 the 17 subsidized lines, plus two that were eligible for subsidy, showed gross operating revenues of about \$122,000,000, of which \$20,000,000 was from mail contracts. The net profit was \$4,000,000.<sup>5</sup>

The pay of American sailors is materially higher than that of any other country, as can be seen from Table 18, which shows comparative wage rates prior to the war.

TABLE 18. SAILOR'S PAY<sup>4</sup>

	United States	Great Britain	France	Germany	Italy	Japan
First Mate .....	\$192	\$102	\$132	\$120	\$62	\$40
Second Mate .....	165	75	65	98	51	32
Third Mate .....	153	59	....	74	45	26
Boatswain .....	85	51	28	50	31	22
Carpenter .....	85	65	28	50	30	20
Able Seaman .....	72	44	24	41	24	14
Ordinary Seaman .....	55	22	21	20	16	12
Chief Engineer .....	317	131	126	181	78	62
First Assistant Engineer..	210	102	94	120	62	40
Second Assistant Engineer	182	75	65	98	51	32

Sudden changes in cargo and trade routes often take place because of tariffs, political and other shifts, and hamper ship

<sup>4</sup> Figures are from table in *Fortune*, September, 1937. Wages are computed at current rates of foreign exchange.

<sup>5</sup> *Economic Survey of the American Merchant Marine*, United States Maritime Commission, 1937.

lines. Many ships have sailed with almost empty holds. Modern foreign commerce demands that regular sailing schedules be maintained, so that ships must sail whether a full cargo is available or not.

The United States Government has for many years subsidized the shipping industry in several ways. In one of the first acts of Congress in 1789 government assistance was given to shipbuilding. Beginning in 1847, various acts were passed providing for attractive mail contracts for American vessels. All coastwise traffic of the United States has since 1817 been limited to American vessels. These restrictions, which include all interior shipping, have been extended to trade with American outlying possessions. The ships must be built in American shipyards and owned by Americans.

During the first World War, the United States was handicapped by having an extremely meager merchant marine. As a result of a high-pressure wartime shipbuilding program, the government found itself at the end of the war with a large fleet of ships which had been built at a cost of about \$3,500,000,000. The government gradually disposed of the larger portion of these ships at an average price of about 10 cents on the dollar. Notwithstanding the inflated wartime costs at which these vessels had been built, this sale of ships represented a substantial subsidy to shippers.

Prior to 1914, the United States had given a total of less than \$45,000,000 to ship operators. Most of this was for carrying mails. From 1914 until the middle of 1940, however, the United States spent a little over four billion dollars to develop shipping. Most of this sum went to build and operate ships, while a small amount was for mail contract payments. As a result of the second World War, unknown billions of dollars must be added to the above figure of government money going into ships.

The Merchant Marine Act of 1920 authorized the setting aside of certain sums of money for loans to shipbuilders at low rates of interest. In the Jones-White Act of 1928, this sum was increased to a revolving loan fund of \$250,000,000, out of which American shipbuilders were permitted to borrow, for

a period of twenty years, as much as 75% of the cost of building a vessel. Ships constructed with the aid of this fund were required to remain under American registry until the loan was completely repaid.

The Act of 1928 provided for ocean mail contracts of a highly lucrative character. The subsidy involved in these contracts was in some cases notoriously large. It was revealed in a Senate investigation in 1933 that one American steamship company in 1929 received an average of \$66,000 for each pound of mail transported. In 1932, American ships carried 65% of America's foreign mail, and received 94% of the total government payment for foreign mail. Foreign ships, on the other hand, carried 35% of the ocean mail originating in America, and received only 6% of the total payments.<sup>6</sup>

During 1933, it was estimated that the government paid \$23,000,000 more for ocean mail service than would have been necessary on a poundage basis. If payment in that year had been made by weight, the government would only have needed to spend about \$3,000,000 for such service. In 1934 mail payments reached their high point of \$27,000,000, exclusive of poundage earnings which were a form of subsidy, since American lines received three times the rate paid to foreign vessels for carrying mail.

This policy of indirect subsidization was strongly criticized during the early nineteen thirties, not so much on the grounds of extravagance as on the grounds that it was not accomplishing its purpose—the creation of a first-class American merchant marine. Although American tonnage engaged in foreign trade was in 1931 second only to that of Great Britain, the average American ship of every type was decidedly inferior to the corresponding British ship. After 1931, the United States declined to fourth place in world tonnage, and in number of ocean-going ships. The subsidy program up to that point was therefore regarded as inadequate.

The Merchant Marine Act of 1936 and wartime construction brought America again to the fore in shipping. Without

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<sup>6</sup> Annual report of the Postmaster General, 1932 and 1933.

continued assistance, however, it appears probable that this country's merchant fleet would again slip back into an inferior position, and expose this country again to the dangers of an inadequate shipping tonnage.

The war has emphasized the importance of possessing a large and modern merchant marine. For military reasons the United States must see to it that the country continuously owns or controls an efficient and large fleet of vessels of all types. It must also possess adequate yards and facilities for constructing ships. The country cannot afford to permit its merchant marine to decline as it did after previous wars. An American merchant marine is helpful to this country's commerce, but the chief reason and justification for maintaining such a fleet at government expense is that of military necessity.

## CHAPTER 33

### AMERICAN FOREIGN ECONOMIC POLICY

International political and economic affairs have become increasingly interwoven. This has accompanied a growing interdependence of the economic life of all nations, together with a greater participation of governments in industry, trade, and financial affairs. Economic activities have extended more and more across borders, and at the same time governments have played an increasingly prominent part in economic activities. Although foreign economic policy and foreign political policy are inseparable, and are indistinguishable over a large area, this chapter deals especially with the economic aspects of foreign policy.

International economic problems have to do with more than the trading of commodities and services and the investment of capital. The economic affairs of nations are so interrelated that few problems can be considered on a purely domestic basis. Full production, the efficient utilization of resources, the attainment of reasonable economic stability, and higher standards of health, nutrition, and education are problems international in scope.

It has often been said that "the flag follows the dollar." This usually was meant to signify that foreign trade and investment were supported by foreign political activity, that where money went the government went also, and that the government usually went in some meddling or aggressive capacity, colonies and provinces sometimes resulting. In the past this has too frequently been the case as regards most governments. It has been the historic custom of European and other nations to back up foreign traders, investors, and concessionaires with guns and battleships. Colonies and foreign possessions have thus often followed foreign investment.

Foreign trade, investment, and economic intercourse, how-



ever, are not necessarily bound up with politics in this sense, with aggression, exploitation, and what has been called economic imperialism. The United States has nearly four billion dollars invested in Canada and a close interlocking of trade with Canada; yet the relations between the two countries are on a most friendly and cooperative basis. The geographic extension of economic activities to foreign areas does not require international political conniving and exploitation as was the custom a generation or two ago.

When an advanced nation has extensive trade and financial interests in a raw material region, in a weak or industrially backward country, an attitude of paternalistic exploitation has in the past been likely to result. Recent years, however, have witnessed a trend away from this approach, in spite of the counter philosophy of the Axis powers. International economic relations are in the process of being established upon a broader and more liberal basis. Leading nations have shown a tendency to base their foreign and colonial policies more upon principles of interdependence and mutual well-being, realizing that economic progress abroad is advantageous to both parties, and that the independent rights of colonial peoples and weaker nations must be recognized. American policy with reference to Latin America, as embodied in the so-called Good Neighbor policy, recognizes that the best kind of a neighbor is a prosperous one with whom good relations are maintained.

**Protecting American Citizens and Property Abroad.**—The long-established policy of leading governments is that their nationals traveling abroad or engaged in legitimate business or other occupations abroad are entitled to protection against violence and to reasonable justice regarding their property. This policy has had important consequences, since often in backward or disturbed countries the local governments are unable to provide such protection or to administer such justice. When conditions have been extremely disturbed, the United States Government has landed troops to provide physical protection for American property and lives.

The more recent policy of this government has been to urge

its citizens to leave those areas where disturbances are severe, so as to reduce the risk of events which might lead this country into war, and to avoid the ill-will which usually accompanies intervention. The government will assist its citizens in departing, but will not assume the obligation of protecting their property, although it will do what it can within limits; nor will it collect debts by armed force. According to the Calvo and Drago doctrines, discussed below, and now accepted by the United States and most other nations, debts shall not be collected by military means.

The doctrine of protecting the person and property of American citizens abroad was emphasized by President Coolidge, when he said: "The fundamental laws of justice are universal in their application. These rights go with the citizen. Wherever he goes, these duties of our government must follow him."<sup>1</sup>

This broad doctrine is obviously difficult to put into practice completely, and has been applied by the United States only in special cases, particularly in China, Mexico, and the Caribbean countries. The enforcement of this doctrine by the United States became considerably less vigorous beginning about 1930, particularly in the Latin American countries.

The matter of protecting the rights and property of citizens abroad is not clearly defined by international law, if by international law we mean a body of rules and principles generally accepted by the nations of the world, although completely disregarded by the Axis powers. Some nations have contended that the advanced and stable countries should give to foreigners the same degree of protection they accord their own nationals, but that weak and disturbed nations must provide foreigners a greater amount of protection than that given the nationals of these weak countries because such latter protection is inadequate. This doctrine, however, is not accepted by all nations. No agreement exists upon the rights of a nation to intervene in other nations in order to protect the property or person of its citizens or assure them fair treatment, but the trend is away from the existence of such rights.

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<sup>1</sup> *New York Times*, April 26, 1927.

Methods of protecting citizens abroad include simple diplomatic representation, pressure of various types, arbitration, and military force. The United States has promoted the policy of arbitration, and has submitted many of its claims to mixed claims commissions.

In the light of Japan's attack upon China, disturbances in the Orient and elsewhere, Secretary of State Cordell Hull in January, 1938 restated American foreign policy regarding the protection of Americans abroad. In a letter to Vice President Garner, he said:

The interest and concern of the United States in the Far Eastern situation, in the European situation and in situations on this continent are not measured by the number of American citizens residing in a particular country at a particular moment nor by the amount of investment of American citizens there nor by the volume of trade. There is a broader and much more fundamental interest—which is that orderly process in international relationships be maintained. . . .

In connection with the problem of affording appropriate protection to Americans in China, there must be kept in mind the fact that we have nationals residing in practically every country of the world . . . and that a policy of abandoning American nationals in any one part of the world would have inevitable and serious repercussions adverse to the legitimate rights of Americans and the legitimate interests of this country in other parts, in most parts, of the world.

In emergency situations such as that which now prevails in the Far East, the government endeavors to pursue in regard to the question of affording appropriate protection a course based upon calm reason.

. . . this government and its officers in China have repeatedly and earnestly advised American citizens, in face of dangers incident to situations of danger, to withdraw, and in the present situation we are making every effort to provide safe means whereby they may depart. . . . When the situation at particular points becomes more tranquil and less likely to present serious hazard to the lives of American citizens, the course is followed of withdrawing armed forces which may have been sent to those points. . . .

**Collection of Debts by Force Banned.**—Until about 1907 most of the leading governments accepted the idea that military means might properly be used, if necessary, to enforce the

collection of debts from defaulting foreign states. Thus, Lord Palmerston declared in 1848 that governments were entitled to demand redress from a foreign state for the legitimate complaints of their subjects, and that when such states had failed to meet their obligations the British Government was prepared, in certain circumstances, to use force. This policy was accepted by Lord Salisbury in 1880.

In 1902 Venezuela had defaulted in its external loans, and was pressed by European powers for a settlement. Failing to obtain this, Great Britain, Germany, and Italy sent their fleets to Venezuela and blockaded the country's ports. German ships bombarded Puerto Cabello. When the use of force against Venezuela was first contemplated President Theodore Roosevelt had said that this government would not guarantee a state against punishment if it misconducted itself, provided that punishment did not involve acquisition of territory by a non-American power. Later, however, when the European nations moved against Venezuela, President Roosevelt protested vigorously, and as a result arbitration took place. The event caused Dr. Drago, the foreign minister of Argentina, to declare the principle in a letter to the Argentine minister in Washington, that "a public debt cannot give rise to the right of intervention, and much less to the occupation of the soil of any American nation by any European power."<sup>2</sup> This proposal, supported by the United States, was not generally accepted at that time, but attention was focused upon the question, and sentiment in favor of it built up.

At the Second Hague Conference, in 1907, a convention was adopted, named after the United States delegate, General Porter, who introduced and defended it, which provided that the contracting parties would not "have recourse to armed force for the recovery of contract debts claimed from the Government of one country by the Government of another country as being due its nationals."<sup>3</sup> This agreement, however, was not to apply if the debtor country refused to arbitrate, or, having accepted arbitration, failed to carry out the award. In the eyes of Latin

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<sup>2</sup> Charles G. Fenwick, *International Law*, D. Appleton-Century Co., 1926.

<sup>3</sup> *Ibid.*

Americans the matter was still not entirely satisfactory, since the United States was unwilling to deny completely the right of intervention. Finally at the Montevideo conference in 1933 the United States accepted the principle that no state could intervene in the affairs of another.<sup>4</sup>

The United States did not oppose the above blockade of Venezuela, but obtained assurances from the European powers that no territorial occupation was contemplated. The so-called Drago doctrine, accepted in 1907, with limitations, was not unlike that enunciated earlier by Calvo, and which bears his name. Calvo was an Argentine diplomat and jurist who wrote a treatise upon international law in 1868. The Latin American countries, which have had many defaults, have thus long contended that military force was improper for the collection of debts, and finally convinced the major countries of the justice of their position.

**Governmental Control over Loans and Investments.**—After the first World War, the United States Government felt it desirable to exercise a certain amount of supervision over the investment abroad of American money, in view of the national interests involved. The Department of State in 1922 requested that bankers intending to underwrite a foreign issue should first consult with it and give it opportunity to object. No new legislation was passed, so that in case the Department disapproved of a loan, the bankers were not legally bound to refrain from proceeding with the flotation. However, underwriters made it a policy to comply with the wishes of the Department, partly because it would be difficult to dispose of an issue that had the Department's disapproval, and also because foreign investors occasionally needed the support of their government in disputes abroad.

The State Department made a practice of not saying that it approved of a loan, but of replying negatively, that it had no objections. The Department looked particularly for features that might cause ill-will abroad, have unfortunate political repercussions, or which were inconsistent with the foreign policy of

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<sup>4</sup> Cf. page 572.

this government, such as the financing of a revolution in a friendly state. The Department also disapproved of loans to small, backward countries wherein the commissions to American bankers appeared exorbitant.

Officials of the State Department made it clear that when the Department did not disapprove of a loan, this was not to be construed either as governmental approval or as an assurance of the economic soundness of the loan. Promoters, however, sometimes endeavored to give the impression that the State Department endorsed the issue and regarded it as safe. They were taken to task about this by the Department. Nonetheless, the public oftentimes regarded the tacit blessing of the State Department as a sign that the loan was secure. When many foreign securities went into default during the depression, and revelations showed some of the abuses and excesses of the loans, dispute and criticism arose over the Department's policy. The Department stated that its concern had always been with the international political effects of foreign issues, and that it had never attempted in any way to pass judgment on the merits of the issues as an investment. The legal status of the Department's actions in reviewing foreign loans was also questioned. The lack of new foreign issues and the changed international situation caused the controversy to die down.<sup>5</sup>

In 1934, following failure of European governments to resume war-debt payments after the expiration of the Hoover moratorium, Congress passed the Johnson Act, which made it a criminal offense to loan to governments which had defaulted, in whole or in part, on obligations owing to the Government of the United States. Private corporations in defaulting countries or political subdivisions which were not in default of their obligations were not affected by this law.

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<sup>5</sup>In 1922, the sale in the United States of bonds of the Soviet Government was disapproved, largely because of Soviet repudiation of public debts and confiscation of American property. This ban was later extended to certain private issues of Russian bonds. Because of widely prevailing sentiment in France against the payment of war debts and the delay of France in negotiating an agreement to arrange repayment, the Department in 1925 advised against all further loans to France. This embargo was lifted gradually. In 1927, the refunding of existing loans was permitted; in 1928, industrial investments were authorized; and in 1929, all restrictions were abolished.

A further governmental restriction on foreign lending was imposed by the neutrality legislation of 1936 and 1937. Lending to nations at war was thought to increase the danger of military involvement of the lender, and to make difficult an effective neutrality policy. The 1936 amendments to the neutrality law of 1935 therefore imposed an embargo on all loans to belligerent nations. The Neutrality Act of 1937, which replaced the previous legislation, also contained this provision.

These prohibitions were largely the product of the isolationist philosophy which gripped the country prior to the attack on Pearl Harbor. They were based on the thought that our entry into the previous war was due to loans extended to the Allied Powers; they were also the result of dissatisfaction over the attitude of European nations toward their debts to the United States.

These measures seriously interfered with the ability of Great Britain to obtain needed supplies in the United States during the first part of the war. The adoption of the lease-lend program in March, 1941, which was to a large extent made necessary by these measures, relieved the situation and resulted in large new loans, not of money but of materials, to nations opposing the Axis.

Since about 1914, an outflow of capital from the United States, irregular at times, has played an important part in this country's export trade and domestic prosperity. The economy of the United States has become organized in such manner that it is dependent upon a large export market. Agricultural and other products are produced in quantities larger than necessary for domestic consumption, according to previous standards. The United States, however, through its tariff policy has discouraged imports, which help to pay for exports, so that exports have been maintained through loans and through gold and silver imports; the United States now possesses most of the world's gold and silver. If exports are to continue in volume they must be paid for by imports, or by further loans. Moreover, this country is a creditor nation, so that many imports will, according to expectations, represent interest receipts and will not create dollar balances with which foreigners can buy American

goods. If loans, therefore, were to be discontinued, the country's export trade would suffer.

The rest of the world needs capital for reconstruction and the development of resources. The United States has abundant capital seeking employment, while large areas exist, particularly in undeveloped parts of the world, where capital can be put to productive use. Improving the equipment and modernizing backward areas raises living standards and expands their purchasing power, creating new markets for American products, including the "surpluses" which are the source of so many political and other difficulties. From the standpoint of competition with American goods, industrialization of these newer areas would alter the types of commodities traded, but instead of interfering with trade would tend to increase total trade, probably creating an increased demand for machinery, heavy goods, and luxury articles.

It is important for several reasons, therefore, that capital investment take place and that American funds continue to flow abroad. If political and economic conditions become sufficiently stable that commercial lending in volume can again take place, such investment will necessarily have to be under close government control. It will have to be related not only to the capacity of the borrower, but also to the possibilities of transferring interest and principal repayments. The purpose of the loan, the type of obligation, whether debt or equity, and the relation of the total volume of investment to business stability are some of the problems requiring careful attention by government.

As the war has emphasized, loans are an important instrument of foreign policy, so that the government must be in a position to control their direction and nature, not only in a negative manner, but positively, initiating loans if necessary and determining their amount and details. The United States Government through the Export-Import Bank has made extensive loans all over the world, particularly in Latin America.

**The Export-Import Bank, an Instrument of Foreign Policy.<sup>6</sup>**  
—In February, 1934 the United States Government established

<sup>6</sup> Activities of the Bank in connection with the financing of foreign trade are discussed in Chapter 20.



the Export-Import Bank of Washington to assist the country's foreign trade, which was far from prosperous. The Bank was originally intended to finance trade with Soviet Russia, which had been recently recognized. Debt negotiations with Russia, however, broke down so that the Bank never financed any trade with Russia. In 1936 it absorbed the second Export-Import Bank, which had been created to finance trade with Cuba, and extended its activities to various parts of the world, especially to the financing of agricultural exports to Europe, and the granting of credits to China.

Of the Bank's capital of \$175,000,000, the Reconstruction Finance Corporation subscribed for and owns the preferred stock amounting to \$174,000,000, while the \$1,000,000 of common stock, subscribed for by the Treasury Department, stands in the name of the Secretaries of State and Commerce, with the exception of the shares of the eleven trustees. These trustees constitute the managing board and are officials of various government agencies. The Bank is authorized to have loans outstanding at any one time of an amount not to exceed \$700,000,000. Funds needed by the Bank are provided by the Reconstruction Finance Corporation.

The original purpose of the Bank, namely, to help finance lagging trade, was little by little expanded to include assisting foreign countries and implementing United States' foreign policy. The loans to China were nominally business transactions, but it was generally recognized at the time that this government was endeavoring to support China in her conflict with Japan, and provide China with much needed dollars.

Extensive loans have been made to Latin American countries, and since about the middle of 1938 (only a few Latin American loans were made prior to then) have been increasingly related to the Good Neighbor policy and to American foreign policy in general. They have been based upon both business and broad economic considerations, aimed not only to assist the Latin American countries, but to promote good relations between these countries and the United States, and to help them combat the growing Axis danger.

The Bank's original resources were considered inadequate

TABLE 19. EXPORT-IMPORT BANK COMMITMENTS BY COUNTRIES AS OF  
JUNE 15, 1942

## LATIN AMERICA

Argentina .....	\$ 61,120,000.00	Honduras .....	\$ 2,700,000.00
Bolivia .....	16,962,000.00	Mexico .....	37,149,291.20
Brazil .....	103,609,529.14	Nicaragua .....	5,150,000.00
Chile .....	29,467,329.54	Panama .....	2,500,000.00
Colombia .....	22,181,385.48	Paraguay .....	6,500,000.00
Costa Rica .....	6,374,607.29	Peru .....	25,000,000.00
Cuba .....	78,478,473.36	Puerto Rico .....	250,000.00
Dominican Republic .....	3,300,000.00	Uruguay .....	19,585,000.00
Ecuador .....	14,255,000.00	Venezuela .....	29,933,000.00
El Salvador .....	1,196,000.00	Miscellaneous Latin	
Haiti .....	13,250,000.00	America .....	96,000,000.00
TOTAL LATIN			
AMERICA ....			
\$574,961,616.01			

## CHINA

Total China ..... 137,416,529.99

## OTHER

Canada .....	\$59,265,000.00
Portuguese West Africa .....	300,000.00
Iran .....	462,429.39
Philippine Islands .....	25,600,000.00
Czechoslovakia .....	794,443.63
Finland .....	35,000,000.00
Germany .....	4,559.00
Iceland .....	1,000,000.00
Italy .....	13,376,264.68
Latvia .....	10,782.03
Norway .....	226,612.00
Poland .....	3,547,411.58
Portugal .....	1,500,000.00
Spain .....	13,681,073.89
Sweden .....	4,111,000.00
Various Countries .....	1,126,978.05

Total Other ..... 160,006,554.25

GRAND TOTAL ..... \$872,384,700.25

for the large operations indicated desirable to meet the threatening international situation, so in September, 1940 the lending authority was increased by \$500,000,000, and the functions and purpose of the Bank defined in a way to leave no doubt that it was to operate as an instrument of foreign policy, particularly in the Western Hemisphere. The new rôle of the Bank was criticized in some quarters in view of the poor debt record of the Latin American countries and the possibility that many of the loans being made there would never be repaid. The Bank, however, has endeavored to hold, as far as possible, to business standards. The indirect benefits and the larger purposes involved, have, of course, been amply justified by subsequent developments.

After the adoption of the new law the Bank expanded its credits to Latin American countries. In December, 1940 it opened a credit of \$60,000,000 for the Central Bank of Argentina to be used in the purchase of American agricultural and other products. The United States Treasury announced at the same time that it was ready to provide \$50,000,000 for exchange stabilization. These commitments to Argentina were followed by commitments in varying amounts to most of the other Latin American countries for a variety of purposes. These purposes have been such as to provide these countries with dollar exchange to meet temporary or emergency situations, to help finance industrial undertakings that are expected eventually to become revenue producing, and to assist in road construction and other public works. From the Bank's creation in 1934 to August 15, 1941, it had extended credits of \$280,000,000 of which \$202,000,000 had been repaid. Commitments of the Bank have continuously been considerably in excess of actual disbursements. Thus on March 15, 1942 undisbursed commitments to Latin America totalled \$344,000,000 compared with loans outstanding of only \$45,000,000. Table 19 shows commitments to all countries as of June 15, 1942.

## CHAPTER 34

### AMERICAN FOREIGN ECONOMIC POLICY

(CONTINUED)

**Relations with Latin America.**—When the Latin American countries broke away from Spain and declared their independence during the early part of the last century, the United States was among the first to recognize the new republics. Furthermore, President Monroe in December, 1823 declared that the European countries were not to interfere in the affairs of this hemisphere—a statement which came to be the basis for American policy in this part of the world.

Until the last few decades, however, the United States did not exhibit much interest in efforts toward inter-American cooperation and solidarity. At the Congress of Panama in 1826, called by Simon Bolivar when President of Peru, the United States was not represented since the Senate failed to approve participation until too late. This first move on the part of the Latin American countries toward Pan-American cooperation was not followed by other conferences until 1847–1848, when several of the countries sent representatives to Lima. During the interval Mexico had on several occasions endeavored to assemble congresses, but without success. A few other conferences were held at scattered intervals, not very well attended, and while nothing concrete came from them, they, nevertheless, indicated that the American republics felt a common bond and had an interest in cooperation.

Finally, in 1889, at the request of the United States, all of the Latin American countries, except the Dominican Republic, sent representatives to a conference at Washington. Out of this conference came the Pan-American Union, established in 1890 as the International Bureau of the American Republics, and

interested at that time largely in commercial affairs. No plans were made for further conferences, but at the suggestion of President McKinley a second conference met in Mexico City late in 1901. At this meeting arrangements were made for a third conference which was held in Rio de Janeiro in 1906. The fourth conference was held in Buenos Aires in 1910, the fifth in Santiago in 1923, the sixth in Havana in 1928, the seventh in Montevideo in 1933, and the eighth International Conference of American States in Lima in 1938. Bogota was selected for the conference in 1943. In addition to these conferences the United States was instrumental in assembling the Ministers of Foreign Affairs at Panama in September, 1939, at Havana in July, 1940, and again the Third Conference of Ministers of Foreign Affairs of the American Republics at Rio de Janeiro in January, 1942. In 1936, at the suggestion of President Roosevelt, there was held in Buenos Aires the Inter-American Conference for the Maintenance of Peace.

In spite of these cooperative conferences, relations between the United States and Latin America were, until recently, not very satisfactory. Actions of the United States were the subject of much criticism, particularly in Latin America, where American policy was viewed with suspicion. At the present time, most of this suspicion has disappeared, and a much better feeling exists. It had been contended that our policy toward Latin America was determined by the interests of traders and investors—"dollar diplomacy"—and also that the United States had territorial aspirations southward. Instances cited of expansion at the expense of Hispanic America were the acquisition of Texas, California, and the Panama Canal Zone. The Monroe Doctrine was characterized as a doctrine of aggression and exploitation. The American Republics were, and not without reason, distrustful of the "Colossus of the North," which in turn was often impatient and irritated, not without reason, at the disturbances and excesses in some of these more backward countries.

The economic and financial penetration of Latin America by the United States has been going on for years, and at an accelerated pace recently. The United States has about four billion

dollars invested in Latin America, and is the leading country in the foreign trade of most of these countries. This relationship is primarily the result of propinquity and natural forces; Latin America has sought contact with the United States and the United States has sought contact with Latin America, to their mutual advantage.

The United States' policy toward these countries was, however, for many years somewhat paternalistic, particularly in the Caribbean countries. The United States frequently intervened in their affairs, and occasionally landed troops to maintain order and support American policy. Such interventions were offensive to the peoples of these countries and contributed to the suspicion and ill-will. The Monroe Doctrine, which has been the basis of American policy in this area since 1823, was gradually expanded from a policy of opposing European aggression in the Western Hemisphere, to that of an exercise of international police power, as President Theodore Roosevelt described it in his annual message in 1904. To Latin Americans the policy of the United States and its support of trade and investment was one of economic imperialism, even though this country's actions were in general upon a reasonably high plane compared to the policies European nations would have pursued under similar circumstances.

The Monroe Doctrine was originally adopted in the interest of this country against conspiring governments of Europe. It meant that the United States would not permit these nations to intrude themselves into the affairs of North or South America. The United States did not want European nations to get a foothold on this side of the Atlantic. Had it not been for the Monroe Doctrine and the firm stand taken by the United States, the South American countries would doubtless today be provinces of European nations, divided up as Africa and other parts of the world have been divided up.

The Monroe Doctrine is fundamentally a policy of opposing that which is inimical to this country's safety, and was not intended as a policy of seeking special privileges for American trade and investment, nor of superintending affairs of neighbors. Secretary of State Hughes emphasized this in 1923, although

his statement was not convincing to Latin Americans. He also declared that the actions of the United States in this hemisphere were not limited by the Monroe Doctrine, but might be determined upon grounds of international right and national security.

The policy of the United States has continuously been to prevent European nations from landing troops in Latin America, and from obtaining even a temporary foothold, since it is well known that such intervention in weak countries has usually meant permanent possession. A result of this policy was that the United States considered the duty of maintaining reasonable order in these countries as devolving upon itself. It was felt that if the United States did not exercise some supervision over disturbed areas, it would be impossible to prevent European nations from doing so. This was the basis for the international police policy which came to prevail. If the United States had been willing, however, to permit the Latin American countries to share in the application of the Monroe Doctrine, as it has recently done, much of the resentment would doubtless have disappeared.

The United States has taken greater interest in the affairs of the Caribbean countries which lie at our doorstep than in the countries farther south. When the United States intervened in Haiti in 1915, Germany was desirous of obtaining a coaling station there and was ready with troops to straighten out the disordered situation. The United States intervened, according to Secretary of State Lansing, to terminate the appalling conditions of anarchy and oppression, and to forestall the attempt of a foreign power to obtain a foothold so near our borders, which would have been a menace to us. To satisfy the demands of European creditors of Haiti, a financial adviser was appointed to see that Haiti made a serious effort to pay her bills.

American troops went into Nicaragua after conditions there under the tyrannical power of Zelaya had become increasingly difficult. The discontent caused by the abuses of his rule led to a state of almost continuous revolution; and all Central America had turned against him. The patience of European nations was tried, and if the United States had not intervened European nations would very probably have done so. In order to satisfy

Europe, the finances of Nicaragua needed to be reorganized. In straightening out these finances, American bankers probably went farther than necessary in the degree to which they became interested in the domestic affairs of the country. Although the program was unpopular in the eyes of Nicaraguans, the country received much permanent benefit.

The United States Government in 1916 bought from Nicaragua canal rights for \$3,000,000. The special interest of the United States in Nicaragua was largely to prevent this canal location from falling into the hands of Europeans. Prior to construction of the Panama Canal, the Nicaraguan canal route competed strongly with that finally selected at Panama. The United States may eventually construct a canal across Nicaragua, although the recent expansion of the Panama Canal has deferred such possible action.

In speaking of Santo Domingo, President Theodore Roosevelt said: "The patience of her foreign creditors had become exhausted, and at least one nation was on the point of intervention and was only prevented by the unofficial assurance of this Government that it would itself strive to help Santo Domingo in her hour of need."<sup>1</sup>

Inasmuch as the European nations had a policy of landing troops when a weak country falls down in its financial obligations, the United States has at various times exerted pressure upon Latin American countries to straighten out their finances in order to forestall European intervention. American interference, however, was upon broader grounds than protecting trade and investment. American policy centered around the idea of not allowing European nations a legitimate reason for intruding themselves into this hemisphere. When order was restored the United States withdrew, but there was no assurance as to when intervention might again take place.

In connection with the loans extended by American bankers to Nicaragua and a few other countries, a collectorship of the customs was established in order to assure repayment. In the case of Nicaragua, an American collector-general collects the

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<sup>1</sup> John Parke Young, "All America Now Lends Money to the World," *New York Times*, August 23, 1925.



customs revenues and, after paying for the expenses of collection, remits to New York the amount necessary to service the loan. The balance is then turned over to Nicaragua. The collector-general is "nominated by the bankers, approved by the Secretary of State, and appointed by the Republic."<sup>2</sup>

Similar arrangements, although differing in detail, have existed in connection with loans to the Dominican Republic, Haiti, Liberia, and Bolivia. In the case of Salvador the loan contract provided that a fiscal representative of the bankers inspect the collection of customs, and that in case of default a collector-general should take charge. However, when Salvador defaulted in 1932, the United States Secretary of State refused to participate in the setting up of an American collectorship, as provided, the reason stated being that the United States had not recognized the existing government of Salvador.

A collectorship of customs by a foreigner is offensive to the citizens of the sovereign country accepting such an arrangement, and breeds ill-will toward the country that made the loan and that appoints the collector.<sup>3</sup> Procedures of this kind are out of harmony with the newer policy of the United States, and will probably not again be utilized.<sup>4</sup>

**Good Neighbor Policy.**—In his inaugural address in March, 1933, President Roosevelt announced a liberal and cooperative policy toward the American states, a policy which has become known as the Good Neighbor Policy. The President said: "In the field of world policy, I would dedicate this nation to the policy of the good neighbor—the neighbor who resolutely respects himself, and, because he does so, respects the rights of others—the neighbor who respects his obligations and respects the sanctity of his agreements in and with a world of neighbors."<sup>5</sup>

<sup>2</sup> John Parke Young, *Central American Currency and Finance*, Princeton University Press, 1925, p. 141.

<sup>3</sup> After the first World War, German finances were administered to a large degree by foreigners. This was a source of friction and offensive to German pride.

<sup>4</sup> Control over Dominican customs was relinquished by an agreement between the United States Government and the Dominican Government signed in September, 1940.

<sup>5</sup> Howard J. Trueblood, "Progress of Pan-American Cooperation," *Foreign Policy Reports*, February 15, 1940.

This announcement was followed by several actions which made the new policy more concrete and convincing to the Latin Americans, notably the position taken by the United States at the Montevideo conference in 1933, together with understandings reached there, abrogation by the United States in 1934 of the Platt amendment which had long antagonized Cuba, withdrawal of marines from Haiti in 1934 and of financial control there, conclusion of a new treaty with Panama, and other measures.

The Montevideo Conference in December, 1933 revealed the basic nature of the change in American policy toward Latin America, in line with the President's previous statements. At this conference the United States renounced intervention, and Secretary of State Hull declared that "under the Roosevelt administration the United States Government is as much opposed as any other government to interference with the freedom, the sovereignty, or other internal affairs or processes of the government of other nations."<sup>6</sup>

As a result of the conference, sentiment immediately became more friendly toward the United States. This good feeling continued to grow, and by the time of the Inter-American Conference for the Maintenance of Peace, called by President Roosevelt and held in Buenos Aires in 1936, much of the traditional suspicion of Latin America toward the United States had disappeared. All of the 21 American republics were represented at this conference which drew up peace machinery acceptable to all.

The results of the latter conference included the so-called Consultative Pact, wherein the nations agreed to consult "in the event that the peace of the American Republics is menaced." Such consultation was to be "for the purpose of finding and adopting methods of peaceful cooperation."<sup>7</sup> This was aimed particularly at European interference in Latin America, although not specifically mentioned in the pact. The Monroe Doctrine was thus in a sense taken over by all the Latin American states.

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<sup>6</sup> *Ibid.*

<sup>7</sup> Charles G. Fenwick, "The Buenos Aires Conference: 1936," *Foreign Policy Reports*, July 1, 1937.

The United States had previously been unwilling to share with other states in any degree the interpretation and application of the doctrine. Secretary of State Hughes in 1923 declared against such sharing, inasmuch as the policy, he said, was distinctly the policy of the United States. At conferences previous to that at Buenos Aires the United States had opposed efforts to have the Monroe Doctrine defined or even discussed. At the Buenos Aires Conference, however, the United States approved of the Consultative Pact, which involved an implied sharing of the doctrine. At the same time, the United States did not relinquish in any way its intention, as embodied in the Monroe Doctrine, of resisting foreign interference in the affairs of this hemisphere.

At this conference in Buenos Aires there was adopted the Declaration of Principles of Inter-American Solidarity and Cooperation. Although this declaration was in broad and general terms and did not contain anything very new, it was a clear statement of principles and ideas regarding the common interests and objectives of the American republics. It was regarded by some of the nations as a form of collective security.

At Lima in 1938 there were some suspicions that the United States was using the threatening situation in Europe to promote its own interests in Latin America. This criticism, however, soon died down, and at Panama, shortly after the outbreak of war, came the general Declaration of Neutrality, as well as the declaration that American waters extended 300 miles off shore—a so-called safety belt. None of the belligerents, however, recognized this safety belt.

When the United States entered the war in December, 1941, this country was promptly followed by the six Central American countries, Cuba, Haiti, the Dominican Republic, and later by Mexico and Brazil. All the South American countries except Argentina and Chile promptly severed diplomatic relations with the Axis powers as recommended unanimously by the conference at Rio de Janeiro in January, 1942. Chile was fearful lest her long coast line be the object of Axis attack. In Argentina the political situation was confused, and the administration in power not entirely unfriendly to the Axis.

In the field of economic collaboration, considerable progress has been made in recent years. The Panama conference in 1939 created the Inter-American Economic and Financial Advisory Committee consisting of one expert from each of the countries. Its purpose was to consider economic and financial problems arising from the war, and also to establish economic relations upon a permanent and mutually advantageous basis. The committee was given authority to consider such matters as currency and exchange stabilization, commercial relations, a possible customs truce, an inter-American bank, and other economic and financial measures.

The Committee in June, 1940 organized as a working unit the Inter-American Development Commission. This commission includes two members from the United States, Nelson Rockefeller being appointed chairman, and three from Latin American countries. It established a national commission in each of the Latin American countries and has been endeavoring to promote trade and production.

An Inter-American Bank was proposed by the Inter-American Financial and Advisory Committee, and a convention for its establishment was prepared in May, 1940. Its capital was to consist of \$100,000,000, and it was to assist in stabilizing currencies, clearing international payments, and in the advancement of commerce and economic relations in general. The United States signed the convention, but the Senate has thus far failed to ratify it. The conference of Foreign Ministers held at Rio de Janeiro in January, 1942 urged further economic and financial collaboration and adopted a resolution recommending the establishment of an international stabilization fund, and that a meeting of Ministers of Finance be convened for this purpose. The Latin American countries have exhibited a great interest in the economic and financial collaboration, which has been encouraged by the United States.

The United States has loaned considerable sums of money to these countries for development and other purposes, and has also made extensive purchases of strategic materials there in connection with the war. It has also furnished technical assistance and made contracts designed to stimulate production by

guaranteeing large purchases at fixed high prices over periods of time. It has entered into exchange stabilization agreements with several of the countries. While the United States has been generous in its assistance to these countries, particularly during and prior to the war, its financial aid has necessarily not always been upon a purely business basis. A continuation of the economic cooperation and good-will, which must be upon a reciprocal and solid basis if it is to be permanent, is mutually advantageous. It is to be hoped that the difficult readjustments of the post-war reconstruction period will not be allowed to halt the progress that has been made.

**Relations with Mexico.**—Relations of the United States with Mexico have been somewhat distinct from those with other Latin American countries, and have put the Good Neighbor policy to the test under rather trying circumstances. A large amount of American capital has gone into Mexico, as into Canada and other neighboring countries. The proximity of Mexico and the influx of Americans and their dollars have created special problems. Mexico like the other Latin American countries does not wish to be dominated by Americans nor by American capital. At the same time Mexico has been endeavoring to carry through a comprehensive program of social and economic reform which, in fact, is in conflict with all capital owners, regardless of nationality. For many years friction existed between Mexico and the United States, particularly with respect to confiscatory provisions in the Mexican constitution of 1917, and to the rights and property of American business interests in Mexico. Improvement in Mexican-American relations followed the Morrow-Calles agreement of 1928. After 1934, however, when President Cárdenas took office, Mexican nationalism, which has been a powerful influence since the 1911 revolution, led to a new campaign against foreign capital and the dominant position which it occupies in Mexico.

American and other foreign interests in Mexico have had to contend with the program of agrarian reform, whereby land is expropriated and given to peasants. In October, 1937, it was announced that during the previous three years 25,000,000 acres

had been taken from the large estates and given to 569,000 peasants.<sup>8</sup> Much of this land was owned by Americans. The constitution provides for compensation to the owners, but the government declared that it had no funds for this purpose. Foreign capital has also been affected by the continued effort of the Mexican Government to recapture natural resources. This was particularly troublesome to the foreign oil companies, which owned about 90% of the Mexican oil industry. In March, 1938, the Mexican Government expropriated foreign oil properties in Mexico. This resulted in strong protests from the United States and Great Britain. British oil properties in Mexico were more extensive than those of the United States. The United States recognized that Mexico had a right to take over foreign properties, provided proper compensation was made. Immediately after Mexico's action the United States Treasury stopped its purchases of Mexican silver.

In addition to high taxation and growing governmental intervention and socialization, foreign capital has been faced with strong demands from labor and an aggressive labor movement with government support. Some of the states have laws permitting workers under certain conditions to take over plants on the basis of twenty-year payments.

The strength and success of the Cárdenas administration were due to a considerable extent to the friendship of the United States, together with the benefits resulting from the American silver-buying program. In January, 1936 the United States Treasury announced it had concluded an agreement with Mexico whereby the Treasury would acquire through the Bank of Mexico practically all of the newly mined Mexican silver. In January, 1938 announcement was made of the continuation of silver purchases from Mexico,<sup>9</sup> but in March, 1938, following the expropriation of oil properties, these purchases were halted as noted above. Metal exports from Mexico, including copper, lead, and zinc, normally constitute about 76% of total exports.<sup>10</sup> Much of the mining industry is American owned

<sup>8</sup> Foreign Policy Association Bulletin, December 3, 1937.

<sup>9</sup> *New York Times*, March 6, 1936, and January 11, 1938.

<sup>10</sup> Carlton Beals, *Sharing-the-Wealth, Mexican Style*, Barrons, December 6, 1937, pp. 8, 9.

(about 50% of the silver output), but mining activity, which has been stimulated by the American silver program, is nonetheless helpful to Mexican prosperity.

In November, 1941 a series of agreements between Mexico and the United States dealt with some of the outstanding issues between the two countries. According to these agreements the United States agreed (1) to spend up to \$40,000,000 to stabilize the peso against the dollar, (2) to buy 6,000,000 ounces of newly mined Mexican silver each month at 35 cents an ounce under the Silver Purchase Act (\$25,200,000 per year)—ever since the oil expropriation silver purchases had been upon a day-to-day basis, and (3) to establish credits at the Export-Import Bank of \$30,000,000 for Mexican road construction, to be available at the rate of \$10,000,000 annually. Mexico agreed to pay \$40,000,000 toward the settlement of all American agrarian and general claims arising between 1927 and 1940—\$3,000,000 to be paid immediately, \$3,000,000 having already been paid, and \$34,000,000 to be paid at the rate of \$2,500,000 annually. The agreements also provided for the appointment of a joint board to appraise the expropriated oil properties.

The controversy over the oil properties centered around the question of sub-soil rights. The oil companies maintained that since their properties were acquired prior to the 1917 constitution, which declared sub-soil wealth to be national property but not retroactively, these properties should include in their value an allowance for sub-soil rights. In April, 1942, the joint board appointed by the Mexican Government and the United States Government to appraise the properties announced a figure of \$23,996,000 as the value of the American-owned oil properties in question. This figure, while considerably more than that offered by the Cárdenas regime, was regarded by the oil companies as extremely low.

The administration of Avila Camacho, who succeeded Cárdenas, has sought to improve relations with the United States and at the same time continue, but less aggressively, the social reform program so actively promoted by Cárdenas. The policy of Mexico is to be understood as an effort to improve the

lot of the Mexican peasant and common worker, especially, and to raise standards of living and improve conditions in Mexico for Mexicans.

**The Open Door Policy.**—American policy with reference to foreign trade, investment, and economic relations, in general, embraces that of the “open door”—equal opportunity for the citizens of all countries. The United States Government does not seek special privileges anywhere for its citizens, and, conversely, demands that its citizens be not discriminated against. It has not, however, been willing to enforce this latter demand by military means.

In the Orient, the United States about the first of this century found it especially necessary to insist upon the open door, since European nations were endeavoring to secure special privileges, politically and economically. Desiring to keep open the Chinese market and to facilitate self-development of China, the United States in 1899 persuaded the European powers and Japan to accept the open door policy. As a result of the Washington Conference of 1921–1922, called by the United States, the open door policy was for the first time embodied in a formal treaty, the Nine-Power Agreement. The firm position taken by the United States against the establishment in China of spheres of influence, of exclusive concessions, and other special favors, obtained often under pressure or in return for money loaned, has been to a large extent responsible for the territorial and economic integrity of China.

The United States protested vigorously against Japanese operations in China, in 1931 and 1932, when Japan created the puppet state of Manchukuo, but did not care to back up these protests with force. This is in accord with the policy enunciated by Secretary of State John Hay in 1901, when he said that this country was not prepared to enforce its views with respect to the Orient by a demonstration hostile to any other power.

In October, 1937, President Roosevelt in a speech in Chicago declared against the military policy of Japan, and also of certain European nations, without mentioning any nation by name. He



announced that an aggressor should be quarantined, and that the United States was ready to cooperate with other powers in preserving the peace of the world. Public opinion, however, was still predominantly isolationist, and subsequent developments showed that this country was not prepared to take vigorous actions to maintain international order. The State Department immediately after this speech declared Japan to be the aggressor in the military activities in China, which assumed serious proportions beginning in the summer of 1937, stating that Japan had violated the Nine-Power Treaty and the Kellogg-Briand Pact of 1928, which outlawed war as "an instrument of national policy." The United States then participated in the Brussels conference of the signatories of the Pact, called to deal with the Far Eastern situation. The conference, however, came to naught. Had Japan not attacked the United States in December, 1941, it appears improbable that this country would have gone to war in defense of the open door.

American policy in the Orient has been based fundamentally upon the maintenance of the open door, and upon the observance of the Kellogg Pact and other treaties of non-aggression. United States financial interests in China are not extensive, investments being about \$200,000,000. The United States, however, ranks first in China's foreign trade.

The outcome of the keen competition early in this century to lend money to China was the formation in 1910 of the first consortium, or understanding between Great Britain, France, Germany, and the United States regarding cooperation in future loans to China. Japan and Russia were soon added to the group. President Taft's administration in the United States was in sympathy with participation in the consortium of American bankers, as a means of strengthening the open door policy and of preventing improper exploitation of China. President Wilson's administration, however, took a different viewpoint. The American group, consequently, withdrew in 1913, since they were unwilling to continue without the support of the State Department.

As a result of the changed conditions brought about by the first World War, a second consortium, replacing the first, came

into existence in 1920 between Great Britain, France, Japan, and the United States, and, later, Belgium. No loans were advanced by this second consortium, which was created upon the initiative of the State Department to protect China against possible exploitation.

**The Neutrality Act of 1937.**—The aims of the Neutrality Act of 1937, superseding that of 1935, were to shut America off as completely as possible from such trade and financial dealings with belligerents as were thought might involve this country in hostilities. It was commonly believed that the entry of this country into the previous war was because of trade and financial dealings with the Allied countries. According to this law, the President, when he found a "state of war" existed between two or more powers, was to issue a proclamation to that effect, which automatically prohibited certain activities, namely, certain trade and financial transactions with belligerents.<sup>11</sup>

The President had considerable latitude in determining whether or not a state of war existed. In 1937 when Japan invaded China, the President did not declare that a state of war existed. Neither Japan nor China desired such a declaration, since it would have seriously interfered with the trade of Japan, and China would have been unable to buy munitions in America. Furthermore, such a declaration would have been more damaging to China, who needed munitions, than to Japan, whom the United States regarded as the aggressor. In addition

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<sup>11</sup> The activities prohibited by this proclamation were: (1) the exportation of "arms, munitions, or implements of war" to belligerent nations; (2) the purchase or sale of securities or other obligations of nations at war, or the extension of credits to governments or persons of such nations; (3) the solicitation of contributions for war; (4) the transportation, by American ships, of war implements to belligerent nations; (5) travel by Americans on vessels of nations at war "except in accordance with such rules and regulations as the President shall prescribe"; and (6) the arming of American merchant vessels.

The embargo on loans to belligerents did not apply to "a renewal or adjustment of such indebtedness as may exist on the date of the President's proclamation." Moreover, the President, at his discretion, could except from the embargo "ordinary commercial credits and short-time obligations in aid of legal transactions and of a character customarily used in normal peacetime commercial transactions."

Cf. Raymond Leslie Buell, "The Neutrality Act of 1937," *Foreign Policy Reports*, Vol. XIII, No. 14, October 1, 1937, p. 169. Quotations from the Act of 1937 are from the text as printed in this study.

to the prohibitions of the act which were automatic in character, were certain other restrictions which the President, at his discretion, might impose.<sup>12</sup>

The Neutrality Act involved a departure in United States foreign policy, and was the outgrowth of isolationist sentiment and reasoning, and the culmination of a strong peace movement in the United States. The act, however, instead of contributing to world peace, had the opposite effect. It amounted to an announcement to other countries that they could go as far as they wished with aggression, violation of treaties, and lawlessness in general, and that the United States would not interfere. The United States was saying, in effect, that the problem of international order and world peace was not its affair. The neutrality and "peace at any price" agitations were thus invitations for dictators to pursue aggressive militaristic policies, and disturb the peace of the world, including that of the United States. The campaigns in Manchuria, Ethiopia, Spain, and China proper were aided by America's policy.

After the outbreak of war the illogical nature of the act, and the harm it was doing to the cause of the nations opposing the Axis, became more and more obvious. Not, however, until November, 1941, did Congress amend the act, permitting American vessels to sail into ports of belligerents, and permitting the arming of such vessels. These amendments emasculated the act, so that while Congress preferred not to repeal it, the effect was similar. Furthermore, the lease-lend program, authorized by Congress in March, 1941, had nullified the provisions designed

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<sup>12</sup> Thus the President could prohibit: (1) the transportation by American vessels of any commodity designated by him, to a nation at war; (2) the exportation of goods in general to a belligerent nation until after "all right, title, and interest" in the goods has been transferred to some foreign government, institution, or person (the so-called "cash-and-carry" policy); (3) the use of American ports as a supply base for warships of belligerents; and (4) the use of American ports by foreign submarines and armed merchant vessels except under "such limitations as the President may prescribe." Cf. Buell, *op. cit.*, p. 169.

Among these discretionary powers, that dealing with the policy aptly described as the "cash-and-carry" policy, was intended, in the words of Senator Borah, "to avoid all risks, all danger, but . . . to get all the profits." By compelling the foreigner to make settlement for exports from this country before shipment, the policy aimed to prevent involvements and disputes which might make a neutral position difficult to maintain. It attempted to prevent repetition of the difficulties which occurred in American foreign trade between 1914 and 1917—difficulties which some persons believed were instrumental in bringing America into the war.

to prevent American dollars from financing belligerents. According to this lease-lend program the government itself provided materials of war to countries fighting the Axis. This amounted to a formal repudiation of the misguided neutrality policy.

**The United States in World Affairs.**—After the first World War, the United States, the strongest nation economically and politically, refused to participate in world affairs, and to exert its influence in behalf of international order, democracy, and free institutions. Conditions reverted to a state of international anarchy, with treaties no longer respected, statements and promises of leading nations not believed, piracy on the high seas revived, weak nations attacked by the strong, civilian populations brutally slaughtered, and freedom of speech and of the press no longer existent throughout a large portion of the world. The economic energies of several nations were admittedly directed primarily toward militaristic and aggressive aims. The democratic nations were losing ground to a reversion to the absolute form of government and all its accompanying abuses.

These developments took place while America stood by and said that foreign affairs did not concern it. Had the United States asserted itself on vital international issues, in a way that other nations would have known that this country meant what it said, it is probable that the disturbed state of affairs and bloodshed could, to a considerable extent, have been avoided. When Japan went into China in the summer of 1937, one of Japan's first concerns was the attitude of America. Japan wanted to be sure that America really meant that it would not fight, no matter what transpired abroad.

The first World War left America in a position virtually to dictate to the rest of the world. Instead of throwing its influence, greater than that ever before enjoyed by any nation, toward the establishment of international law and order based on enlightened practices, the United States washed its hands of events abroad and failed to take the fruits for which it had been fighting. The aim to "make the world safe for democracy," which was the principal reason for entering the war, thus became an

empty phrase, in fact, one of ridicule and cynicism. The United States acted as though a military victory was all that was necessary to accomplish this end. Domestic politics and the desire to discredit Woodrow Wilson were largely responsible for America's non-cooperative course, and therefore for the failure of the League of Nations.

As the new war came closer to the shores of the United States this country slowly realized that it could not be isolated, either economically or politically. It accordingly began to expand its armament, still, however, regarding the war as remote and unreal. The United States today is realizing that it has much in common with the other nations of the world; it has as much if not more than did the original thirteen states with each other.

The maintenance of order and stability in the world, economic as well as political, is vital to this country, as the war has made clear. The attainment of these aims obviously requires some form of international organization with authority and power of enforcement. The world has advanced to the point where further progress demands an organization or some type of machinery to deal with international affairs, which include many affairs often considered domestic. Order requires rules or laws, and also the enforcement of such laws, the absence of which was illustrated by the chaotic condition leading up to the war.

In an international organization the United States now realizes that it must play an important part if success is to result. The absence of the United States was the principal reason which prevented the League from becoming a powerful factor and developing into a more representative body. The League of Nations, nevertheless, accomplished a great deal, its economic work being particularly significant. The old conception of national sovereignty must be modified if a new organization is to succeed. The extent to which nations are prepared, however, to surrender sovereignty to a broader authority remains to be seen. Under any conditions, the United States and Great Britain have much to gain by close cooperation.

Maintenance of international order does not necessarily require the use of military force, although it requires the existence

of such force. The application of economic penalties, or sanctions, against offending nations is a powerful weapon of restraint as yet not extensively tried. If vital articles such as petroleum, steel, cotton, and food are shut off from a nation, it cannot long hold out. The successful application of sanctions rests upon the extent to which a nation is dependent upon foreign materials, its stock-pile, and, of course, the extent of cooperation among other nations in shutting off an offender. The imposition of sanctions against Italy when she went into Ethiopia collapsed when Italy threatened naval action against Great Britain and France. A strong defensive front and readiness for possible conflict are thus necessary—if nations are to be allowed to have independent control over military establishments. The nation being punished must be convinced of the inadvisability of reprisals. If the world should become organized on a broader basis with some form of an international police force, the situation would then, of course, be different.

Sanctions against Japan were actively discussed when Japan attacked China in 1932, and again in 1937. America was inclined toward a vigorous policy in 1932, but Great Britain was hesitant. In 1937, Great Britain was threatened in the Mediterranean, but was nevertheless willing to follow if the United States had led the way. Sentiment in the United States, however, was not prepared for a strong stand against Japan, although unofficial boycotts were extensive. President Roosevelt, in his speech in Chicago in October, 1937, indicated that this country was prepared to cooperate with other nations in quarantining Japan. The reaction of the country to this speech revealed that a large portion of the population were still thinking in terms of "peace at any price," believing that this policy would bring peace and security. The United States participated in the Brussels conference of the signatories of the Kellogg-Briand Pact in 1937, but was unwilling to take the lead against Japan. If the United States was unwilling, it was not to be expected that any other nation would do so.

As a background for international peace and order it is necessary that the numerous restrictions and barriers to trade be removed. Nationalistic economic policies must give way so

as to permit a freer flow of goods throughout the world, and nations must be permitted to develop markets wherever they can compete successfully. Furthermore, the world's resources must be available to all nations on equal terms, so that nations can be assured of free access to whatever raw materials and other products they need. These and other liberal objectives were set forth in broad general terms in the joint statement issued in August, 1941 by President Roosevelt and Prime Minister Churchill, known as the Atlantic Charter. They have also been formally stated at various times by Vice President Wallace, Secretary Hull, and other government officials. These questions are discussed further in the next chapter.

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ATLANTIC CHARTER.—The so-called Atlantic Charter or joint declaration is as follows:<sup>13</sup>

The President of the United States of America and the Prime Minister, Mr. Churchill, representing His Majesty's Government in the United Kingdom, being met together, deem it right to make known certain common principles in the national policies of their respective countries on which they base their hopes for a better future for the world.

FIRST, their countries seek no aggrandizement, territorial or other;

SECOND, they desire to see no territorial changes that do not accord with the freely expressed wishes of the peoples concerned;

THIRD, they respect the right of all peoples to choose the form of government under which they will live; and they wish to see sovereign rights and self government restored to those who have been forcibly deprived of them;

FOURTH, they will endeavor, with due respect for their existing obligations, to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity;

FIFTH, they desire to bring about the fullest collaboration between all nations in the economic field with the object of securing, for all, improved labor standards, economic advancement, and social security;

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<sup>13</sup> Department of State Bulletin, Vol. V, No. 112; August 16, 1941.

SIXTH, after the final destruction of the Nazi tyranny, they hope to see established a peace which will afford to all nations the means of dwelling in safety within their own boundaries, and which will afford assurance that all the men in all the lands may live out their lives in freedom from fear and want;

SEVENTH, such a peace should enable all men to traverse the high seas and oceans without hindrance;

EIGHTH, they believe that all of the nations of the world, for realistic as well as spiritual reasons, must come to the abandonment of the use of force. Since no future peace can be maintained if land, sea or air armaments continue to be employed by nations which threaten, or may threaten, aggression outside of their frontiers, they believe, pending the establishment of a wider and permanent system of general security, that the disarmament of such nations is essential. They will likewise aid and encourage all other practicable measures which will lighten for peace-loving peoples the crushing burden of armaments.

FRANKLIN D. ROOSEVELT  
WINSTON S. CHURCHILL



## CHAPTER 35

### THE UNITED STATES AND RECONSTRUCTION <sup>1</sup>

The inter-war period, in spite of the exchange breakdown and a mounting mass of trade and other restrictions, saw the development of a high degree of interdependence between nations and an interlocking of production, trade, and business generally. The extension of business and financial interests across national boundaries—through the establishment of branch plants, the activities of international cartels and in other ways—proceeded in the face of the movement toward autarky. The economic affairs of nations have in the modern world become so inseparably interwoven in spite of the political turmoil, that to deal with questions of international economic reconstruction is to deal with the whole gamut of economic affairs.

So-called "international" economic problems arise to a large extent out of the existence of a multiplicity of sovereign political states, and from the divergent and oftentimes conflicting economies set up within those states. Distinct from these are problems which would not disappear were the borders to disappear. It is difficulties growing out of the nationalistic organization of the world—such as currency and exchange derangements and barriers to the movement of goods—which are frequently the most troublesome and damaging.

So long as the world is to have a number of sovereign and distinct political systems, with a variety of currencies, banking systems, trade policies, subsidy programs, and other measures, there will continue incomplete and uneconomic utilization of the world's productive resources. The extent and acuteness of the

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<sup>1</sup> Much of the material in this chapter is from the author's article "Problems of International Economic Policy for the United States," *American Economic Review Supplement*, March, 1942.

difficulties will depend largely on the degree and type of co-operation among the few leading nations.

**The Post-War World.**—In approaching the question of post-war readjustment we are faced with the fact that we do not know the extent to which the world will break with tradition and accept political arrangements permitting a freer development of trade and industry throughout the world, thereby releasing some of the strong forces of economic expansion everywhere pressing forward but throttled by political conditions; nor, on the other hand, do we know the extent to which nationalistic rivalry and economic warfare may continue.

Planners of peace everywhere are hoping for a new day in world organization. They would like to envision the rise of an authority able to prevent not only physical violence but also economic violence in relations between peoples—an economic and political order which would permit realization of the vast productive possibilities, a flood of real income which is waiting to be tapped. It has become increasingly clear that the only satisfactory solution to the problems which have torn the world for so long, with increasing violence, is through the establishment of an international authority, with power of enforcement.

National sovereignty must eventually yield to a broader sovereignty, but do we dare expect a radical shift in this direction in the post-war period? We must deal with the world as it is, as well as with the way we should like it to be. Considering the practical limitations of statesmen and legislative bodies, to what extent is it likely that the historic attitude toward national sovereignty, with its economic impedimenta, can be modified? While no answer is possible, it is reasonable to expect that at least a substantial amount of cooperation can be achieved. In place of the large number of independent nations created after the last war—one of the mistakes of the peace settlement—we may have fewer nations, with room within each for the free expression and development of racial cultures and institutions. The size and number of nations, however, is less important than the character of the economic relations between them.

The predominant position held by the United States and

Great Britain indicates something of the framework of the post-war economy and points toward the restoration of multilateral trade and as free a system as is consistent with a large amount of government control. The course of post-war developments depends greatly upon the extent and skill with which the United States assumes the leadership and responsibility which the world awards it and the extent to which the two English-speaking countries can work together for the common good.

**Objectives.**—Whether we approach the international economic problem from the standpoint of American self-interest or of world-wide interest is largely immaterial, since in most cases the two interests run parallel; measures designed to benefit one nation at the expense of others are likely to be boomerangs, inviting retaliation and leading to a cumulative situation similar to that of the recent past.

Two broad objectives for American foreign economic policy stand out. *First* is the matter of maximizing production based on the establishment of reasonably free economic relations generally throughout the world—including the restoration and expansion of multilateral trade—on the assumption that no other system or trading device promotes as successfully maximum production of goods and services in response to free choices of consumers as that of relatively free enterprise and markets, subject to such control as experience indicates. *Second* is the matter of attaining as high a degree as possible of economic stability, national and international. These two objectives comprehend the all-important problem of achieving economic stability at a level approaching full production reflecting free choices, domestically and on a world-wide basis. They are fundamental to political stability nationally and internationally. The matter of an “equitable” distribution of income (whatever that may be) is outside the scope of this book. The attainment of these aims involves political as well as economic considerations, but we shall deal here only with the economic, even though the two are inseparably intermingled.

I. MAXIMUM PRODUCTION.—The merits of multilateral trade and a liberal system of economic relations generally have been

carefully analyzed by others.<sup>2</sup> Bilateral trading arrangements, exchange control (excluding that aimed to stabilize rates at the general equilibrium level), clearing agreements, and the other restrictive devices that usually accompany each other, may, in special and usually temporary instances, serve a useful purpose, such as when regular trade has broken down and emergency conditions exist; but almost invariably they yield an ultimate net loss for all parties. They narrow the range of choice for buyers and sellers, as well as reduce production and the volume and gains of trade. Most of the devices originated as substitutes for more desirable methods. Although Great Britain was tending toward bilateral balancing, this was through force of circumstances.

The trend toward government intervention and participation in all phases of economic life, intensified by the war, has not always been directed toward maximum production in harmony with consumers' desires. Government intervention has too often had the result of narrowing production and of damaging foreign countries. In a world of controlled economies, wherein domestic control programs have international ramifications, American policy and procedure must consider the matter of international coordination of controls. It must also see that this country's interests are protected, in so far as this may be necessary. With economic activities having become an inherent part of government procedure and with trading conducted by large units owned by government or working closely with government, the former conception of free trade—complete *laissez faire*—no longer fits conditions. The trend toward expanding functions of government has everywhere received an impetus from the war, and governments are not likely to relinquish their control over trade and foreign economic relations. Furthermore, governments have definitely accepted welfare economics as a basic policy, and will direct their actions to this end—a most significant shift.

Proponents of extensive government regulation believe that the international order will not attain balance nor function ade-

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<sup>2</sup> Cf. Howard F. Ellis, "Exchange Control in Central Europe," *Harvard Economic Studies*, p. 69. J. B. Condliffe, *The Reconstruction of World Trade*.

quately unless directed by a large amount of conscious guidance. They do not rely on competition, free markets, and prices to provide a stable, efficient, and satisfactory system. They fear significant maladjustments in the volume of production of important commodities, particularly raw materials, lack of balance between countries' payments and receipts, overinvestment, and all the disturbing developments that surround cyclical fluctuations. One aim of control is the elimination of abuses and the enforcement of rules of play, while beyond this is the thought that a free system is incapable alone of bringing full utilization of productive resources and stability, not only domestically, but internationally.

How far government regulation should go, domestically and internationally, in directing economic affairs and determining the details of production and trading, beyond setting the stage and enforcing the rules, is a question which has no precise answer. On the one hand, regulation is not inconsistent with maximum psychic income (i.e., production), with the principle of free enterprise, nor with international equilibrium; in fact, "economic" regulation promotes these objectives. Management alters equilibrium, but there is no reason to assume that an entirely uncontrolled equilibrium is in itself any more desirable than a controlled one. On the other hand, directing in detail the course of production and trade, its nature and volume on an international scale, without doing violence to free choices of consumers and reducing net psychic income, requires a high level of governmental competency and integrity.

If the United States should succeed in restoring a reasonably free system of international trading, together with relatively stable political conditions, could it rely on automatic forces to bring reasonable economic stability, to promote investment throughout the world, and to bring full production and keep it and trade in ultimate balance? Regardless of our views on the degree of control which is necessary, control is here and must be recognized.

Regulation has heretofore been on a national basis for national objectives. This leads to conflicting situations and to economic warfare. We have had national controls and international

anarchy. Currency and credit policies, commodity stabilization programs, and other measures have too often been discordant. Cartels and monopolies operate internationally, but have been controlled nationally under nationalistic philosophies in a manner detrimental to the international economy—often detrimental also to those groups whom they were intended to benefit. Procedures like the Stevenson Plan which turned out to be a boomerang for rubber growers, the American cotton program which encouraged the planting of cotton abroad, the Chilean nitrate monopoly which was damaging to the Chilean nitrate industry, the American silver policy which was disastrous for China and then paradoxically a benefaction—all have had profound international repercussions. They have been directed primarily toward the benefiting of special national groups.

Regulation must be on a much broader basis than conferring domestic favors, usually at the expense of consumers, or seeking national advantages which are harmful to other nations. Such regulations ultimately restrict production and tend to interfere with specialization and the efficient utilization of resources. Management programs that are undertaken must be coordinated internationally and pointed toward the general good. The necessary background for maximum production can thus not exist when nations pursue control programs narrowly conceived, or independently executed. The amount of control that is most conducive to full production and employment cannot be stated in absolute terms, but must remain flexible, changing with conditions. Multilateral economic intercourse based on the principle of free enterprise, modified as circumstances may require, appears at present to offer the most promising results.

2. INTERNATIONAL ECONOMIC STABILITY.—The attainment of full production, not only occasionally but continuously and internationally, i.e., world-wide economic stability, is a major peacetime problem to which governments must give their best abilities. In addition to being terrifically wasteful, depressions are breeding places for political and economic turmoil of the most disastrous kind. The collapse which began in 1929 brought a period of confusion which was to a large extent responsible

for the subsequent disastrous state of affairs. Post-war budgetary problems, in fact all fiscal, economic, and political problems need not be as burdensome as after the previous war if full employment is maintained.

Interdependence has reached a point where domestic stability and international stability are inseparable, and neither can be accomplished by domestic devices alone. It is only necessary to recall the failure of the Credit Anstalt in Austria, the abandonment of the gold standard by Great Britain, or the tension preceding the war to realize how intimately interwoven are economic systems and how sensitive they are to events elsewhere. Domestic stability is unattainable in the face of international instability, unless we are to revert to complete autarky and insulate ourselves against foreign activities, reducing our standard of living accordingly—which state of affairs is in fact also unattainable as a practical matter. Even though autarky were attained by a large, diversified nation such as the United States or Russia, the effect upon the outside countries would be unsettling. The problem of economic stabilization must be dealt with on international lines.

The United States must therefore concern itself with a joint endeavor on the part of the major nations to attack the problem of depression and to see that the world's economic system functions with reasonable completeness. For this purpose there will need to be coordination with particular reference to such things as currency and fiscal policies, and international plans for the stabilization of certain commodities.

Public opinion in the future will be much more intolerant of depression with its unemployment and distress than formerly. Workers will ask, if the government could make industry run at full speed to produce for war, why can it not also make industry produce for peace? Unless governments can find a way, they will be threatened with grave consequences.

The United States, with serious maladjustments—such as agricultural “surpluses,” exports dependent upon either gold inflow or ever-growing foreign credits, chronic underemployment and depression before the stimulus of war spending, and excess capacity of certain plants when peace is restored—must

consider carefully the means of obtaining a stable and efficiently functioning international order.

**Economic Nationalism.**—Under controlled systems the danger is great that policies will conflict, and that as a result costly rivalry will break out. If national sovereignty continues intact in the economic field and if coordination fails or is inadequate, so that government practices abroad or the activities of foreign trading units are insensitive to international effects, it will be necessary for the United States to enforce compensating and protective measures. While economic warfare of this nature is damaging to all nations and should be outlawed, the United States must be prepared to meet it. The United States cannot again permit trade to be out of harmony with the country's foreign policy, as it was, for example, so strikingly in the case of trade with Japan prior to the war.

The current merging of military and economic warfare requires either the outlawing of both or strong defensive equipment in both fields. The effectiveness of economic weapons has recently been demonstrated, and the United States is extremely powerful in the economic as well as in the military field. It may be that economic sanctions will replace military operations against recalcitrant nations. Sanctions, however, are ineffective unless supported by a superior police power. In any event, the United States must mobilize its economic forces effectively.

The executive needs ample authority to meet situations as they arise. Controls in the United States with respect to foreign economic relations are at present somewhat decentralized and are exercised by such agencies as the Board of Economic Warfare, Export-Import Bank, and other Reconstruction Finance Corporation subsidiaries, Maritime Commission, Treasury Department, State Department, Commerce Department, Federal Reserve Board, and other agencies. The regulatory activities of many of these antedate the war and were then used to implement foreign policy. After the war there will be needed a careful study to determine the most appropriate administrative machinery and techniques for supervising and directing the country's foreign economic relations.



**Specific Problems.**—Apart from the immediate post-war problems of an emergency nature, such as providing the world with food and supplies, problems requiring specific action have to do particularly with (1) tariffs, trade agreements, and direct control over the movement of goods, (2) currency and the exchanges, and (3) foreign loans and investments. Trade and the pattern of production have been drastically altered by war needs, by blockades, lend-lease operations, exchange control and other war activities, so that problems of post-war surpluses and also shortages arise. Trade is now badly out of balance and large sums are awaiting transfer. Long-range policy must give way temporarily to emergency measures having to do with readjustment to peacetime economy and efforts to sustain Europe, preventing collapse and economic chaos. We shall consider the above problems primarily from the long-range standpoint.

**MOVEMENT OF GOODS.**—A freeing of trade from oppressive restrictions is essential not only for the major reason of promoting specialization, factor efficiency, and maximal gains, but also to facilitate the making and servicing of foreign investments and to reduce exchange difficulties. In a world of diverse currencies, where foreign payments between nations and sudden capital movements have become large, barriers to the movement of goods interfere with equilibrating adjustments, and increase the strain on the exchange mechanism. Furthermore, such barriers—particularly their constantly changing nature—foster instability. It is significant that economists close to the trade agreements program report that reduction or complete removal of import duties caused far less damage and dislocation to industries than was feared by interested producers,<sup>3</sup> and that in their opinion the shock of adjustment if free trade were to be introduced has been greatly exaggerated.

Apart from the many other reasons, it is axiomatic that the United States, in harmony with its creditor position, must be willing to accept imports if it is to facilitate payments on its foreign credits and avoid the mistakes of the past two decades.

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<sup>3</sup> Constant Southworth, *Toward Free Trade in Latin America* (Foreign Policy Reports), October 1, 1941.

Unless the United States wishes to add to its gold in Kentucky, or forfeit its credits, the inflow of goods must not be impeded.

Efforts in the United States to free trade from tariffs and other barriers have heretofore met with only limited success. The trade agreements program, in spite of its noteworthy accomplishments and surmounting of political hurdles, has been slow and inadequate in comparison to the task to be performed. It has, however, been a refreshing change from an extreme situation with the trend strongly in the opposite direction. A drastic slashing of duties is needed, in return for foreign reductions if such reductions are not otherwise forthcoming, but nevertheless not dependent thereon.

Empire preference was largely a measure of self-defense in an irrational world, and, together with the many obstructing devices of other countries, will doubtless die with the pre-war system, provided the United States is willing to pursue a policy looking toward a freer international order. If the United States, however, insists on retaining trade barriers, it cannot expect the rest of the world to do differently.

The methods of the trade agreements program have demonstrated their practical merit. This procedure, therefore—but on a much broader and more vigorous scale—holds possibilities for a systematic reduction of barriers with a minimum of disturbance to industry. Such a program might be superimposed upon an extensive initial reduction. To be successful this procedure would require ample executive authority, exercised fearlessly. For political reasons tariff reductions cannot easily be accomplished through legislative procedure.

Experience shows that periods of crisis and emergency are ones in which major changes can be accomplished most easily. It also shows that post-war periods are usually times when demands for tariff protection are strong, and are to a large extent granted. The industrialization of raw material areas, stimulated by the war, may bring a world-wide demand for protection.

Post-war periods are ones of flux and shifting within industry; periods of extensive adjustments to new conditions. At such times sharp reductions in certain rates could be made with the least harm. In view of the disturbing industrial read-

justments necessary, however, care should be exercised that reductions of duties, if achieved, do not aggravate a situation which will be difficult enough.

A world of controlled economies is not inconsistent with a minimizing of national boundaries, permitting production and trade to proceed on the basis of comparative advantage and interdependence. Freeing trade from restrictions and opening the door to payments from abroad cannot, however, be a blanket procedure conferring complete license. In releasing trade from its former shackles it is necessary that government retain extensive control, for reasons of both domestic and foreign policy. The type of control, however, is a matter which should receive careful attention.

The United States, through the Board of Economic Warfare and various government corporations, has not only exercised direct regulation over the flow of goods in and out of the country, but has engaged in purchase and sale operations on a large scale, such as those in rubber and metals. Decisions must be reached as to the extent to which the government will retain its direct control over the flow of trade, and engage in commodity operations. Whatever these decisions may be, they reflect underlying social and economic trends. They have far-reaching implications.

**CURRENCY AND THE EXCHANGES.**—The question of currency and the exchanges is dealt with only briefly, inasmuch as this subject has been discussed in other chapters.

The fact that the world has a variety of independent national economic systems is nowhere more disturbing than in the field of currency. The necessity of having to convert values from one currency into another and the uncertain relationship between currencies depresses trade and financial dealings and impedes economic expansion. The regional flow of capital, which constantly takes place within a single nation, is interfered with or stopped entirely when conversion into another currency unit is necessary. A reliable medium of exchange and standard of values is elemental for production and trade, yet for international transactions such a unit is notably lacking.

An international currency system appears to be an impractical goal under present conditions, but the nearest approach to it is found in stable and secure exchange rates based upon co-ordinated currency and fiscal policies. If fixed rates are to be successfully maintained, equilibrium must be secured at those rates—not an easy task. In the absence of price specie-flow forces, currency and credit policies must be coordinated to maintain as far as possible balance between the major countries, and also with a thought to conditions of employment and business generally.

In such a system, gold would be useful for purposes of international clearing. Temporary maladjustments, political disturbances, and flights of capital would put a strain on pegged rates which could be combated by a combination of gold transfers, preferably by debit and credit, stabilization credits if necessary, and exchange control devices. Unless the source of the trouble were relieved, however, such measures would be only expedients and the rates would ultimately break down, which indicates the magnitude of the task. Furthermore, exchange stability is well-nigh impossible in the face of political instability and economic warfare.

Plans for dealing with the exchange problem after the war must contend with a strong demand for dollars, large sterling balances especially difficult to transfer in view of Britain's trade position and loss of foreign assets; also a large amount of "frozen funds" in the United States and some accumulation of dollar balances held particularly by Latin American countries (an offset to the demand for dollars), and an unknown but large volume of German marks owned in occupied and other countries which are in large measure an outgrowth of the bilateral trade agreements Germany has imposed on the Continent. The immediate problem is to hold rates as stable as possible, and to work gradually toward levels in approximate harmony with equilibrium positions and internal purchasing powers.

Stabilization of the pound-dollar rate and full cooperation between England and the United States in monetary policy would provide a large part of the world with the equivalent of a single unit and other countries with a strong currency to which

to tie. A linking of the sterling area and the dollar area would soon encompass most of the world; and the currency policy pursued by these two major countries would set the pace for all others. If administered so as to promote stability at home, such a combination would be a powerful influence for international economic stability. Isolated breakdowns away from the pound and dollar would not seriously disrupt world affairs. Regardless of whether such a combination is realized, the dollar will doubtless be the world's dominant currency.

In the coordination of currency policies a beginning was made in the informal conferences that Benjamin Strong instituted with the heads of the central banks of Europe. Since that time there have been the Tripartite Currency Agreement and other stabilization and cooperative efforts, formal and informal. The matter is at the heart of the larger problem of the international economic system generally, and is of such great significance that the United States must explore practical methods, through formal agreement, for intimate monetary collaboration with Great Britain and other countries, as well as how to administer its own dominant monetary position.

FOREIGN LOANS AND INVESTMENTS.—A large amount of capital is needed by other countries for reconstruction as well as for modernization and the exploitation of abundant undeveloped resources. Opportunities exist everywhere for funds to be put to productive use, to develop backward countries and improve living standards, but their employment abroad has heretofore been hampered by political instability, fear of governmental measures, the exchange breakdown, and unreliable international financial machinery. Such barriers to the export of capital and its widespread investment are barriers to efficient and full production and to progress generally.

America is in a position to supply an abundant amount of capital, benefiting itself as well as the recipients, provided conditions essential to the extension of loans and investments can be fulfilled. In analyzing what these conditions are, we are again confronted with the fact of government participation in economic affairs, including the matter of foreign lending.

Foreign investments take place either in response to the profit motive or are initiated by government, in which case they usually represent public money. If free enterprise is to continue and capital is to go abroad in search for profits, conditions favorable to this which must be established include, in addition to those essential to domestic investment, reasonable international and political stability, freedom from excessive nationalistic restrictions including those on the transfer of funds, and secure currency relationships.<sup>4</sup> If these conditions are not established sufficiently to encourage much capital to seek foreign investment, the government, already a large lender domestically and internationally, must continue in this rôle. It is important for several reasons that loans be made so that government lending may be necessary.

The United States' economy is geared to the need of substantial exports, particularly in the case of agricultural products. The country today finds itself with agricultural "surpluses" which owe their origin partly to a falling off in foreign demand. Industrial capacity has also been adjusted to a large export trade. For several decades, however, America's exports have not rested on imports of goods and services but have been supported in various ways. The maintenance of exports during the twenties depended to a large extent upon continuous foreign loans, granted recklessly. The recovery of exports during the past eight or ten years has been financed by gold imports, silver purchases, and loans. Exports have recently been going out under lend-lease and other arrangements. Not since 1914 have exports been free from support, apart from that of goods and services. In other words, ever since this country shifted during the first World War from a net debtor to a net creditor, the excess of merchandise exports, which was logical to our former status, has continued. Exports have not been fully paid for by goods and services received, but have depended upon loans and items of a special nature. To cease lending would thus be to deal a serious blow to the country's exports at a time when readjustment problems are severe.

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<sup>4</sup> In some cases restrictions on the movement of goods encourage capital to be invested in foreign plants. Canada has been such a recipient of capital.

The war has made the United States a substantial creditor of the world—more so than when the war commenced. Allowing for the non-repayment of many credits, this country still has due it large annual interest payments. To the extent that imports are used for interest payments they are not available to pay for exports, so that in the absence of loans exports might suffer. The release and repatriation of foreign funds now frozen in this country should help somewhat to provide a supply of dollars and sustain our export trade.<sup>5</sup>

Loans must also be depended upon if gold is to be redistributed for purposes of international clearing, since foreigners will prefer to use their available dollars for our goods rather than for our gold. The influx of this gold was due to an unbalanced situation and its outflow, if this were to result from “natural” forces, would also have to be the consequence of disequilibria. Gold loans are therefore necessary for its redistribution.

This country cannot be guided in its foreign lending solely by business standards of credit risks. The last war showed that the most critical economic period is that which begins when hostilities end. What happens abroad after the fighting stops is of profound significance to this country. The United States must help to finance reconstruction and readjustment, and prevent the political and economic chaos which followed the last war. This country must for a time feed Europe and other areas and supply some of the tools and equipment to get peacetime industry functioning.

The war has caused the United States to build many plants and industrial facilities which cannot be operated profitably in peacetime. Some plants can be converted to other purposes, but a large number cannot be made commercially profitable. Furthermore, this country's excess capacity in certain lines is duplicated in European countries. In addition, the war, like its predecessor, has encouraged industrialization in previously undeveloped areas, notably Latin America. In this connection it is

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<sup>5</sup> Even though the United States is a creditor nation and should accordingly accept large imports, the country's foreign trade may show a balance of exports more or less indefinitely, since this country may be a source of capital for a good many years to come.

to be noted that the government is a part owner in many of these undertakings. Of the war industrial plant expansions in the United States approved through March 31, 1942, 82% were financed with public funds.

An outlet for part of the surplus products can be found by developing and supplying equipment to some of the backward countries, opening up their transportation, raising living standards, and improving their productivity and ultimate buying power. Immediately we run into the problem of a lack of current purchasing power on the part of potential buyers, so that loans are necessary. Loans to undeveloped areas and to those which are backward socially can, in this manner, be used to improve conditions, thereby creating new wants, purchasing power, and trade. If backward peoples can be modernized, agricultural surpluses would largely disappear and large demands for United States goods would be created. Experience shows that industrialization of new areas does not cause competition which need be feared, except, perhaps, for a few special articles, but rather expands desires and buying power there for the goods of others. It is doubtful, however, whether private funds will flow of their own accord into backward areas in sufficient volume to bring economies there to a modern basis.

If and when political stability is established, commercial lending may have an opportunity to become important, and it is possible that the American capital market may be drawn on heavily all over the world. Financing by equities in preference to debt has much to commend itself in international affairs, and also avoids some of the risks of currency uncertainties. The United States, however, must give more attention than formerly to the purposes of the loans and see that the loans are put to constructive uses.

Foreign loans and investments have profound consequences, political and economic, so that private lending will need to be under closer government supervision than formerly. This is particularly the case in view of the effects of fluctuations in the aggregate amount of investment upon the level of business activity. Moreover, the government should at all times be prepared to supplement private lending, especially if foreign policy,



as implemented through loans, is to be more than a negative matter; i.e., the prevention of undesirable loans. Loans are a major instrument of international economic policy as the past few years have emphasized, and can be used to advantage for all concerned, particularly if the United States is willing to assume a position of international leadership and responsibility.

The appropriate governmental machinery for controlling and initiating foreign lending operations should be part of a general study of the administrative facilities and techniques for directing and controlling the country's foreign economic relations. Such control should probably reside in a joint board representing several governmental agencies.

In approaching the question of foreign policy we must recognize that the distinction between domestic economic affairs and international economic affairs is becoming more and more one of artificialities, and that the problem has to do with not merely the purchase and sale of commodities but with economic relations in the broadest sense, and with human beings not only at home but everywhere. Cooperation is essential, and in some manner we must find a way to create joint bodies with responsibility and authority buttressed by—and this is vital—power of enforcement. Much of the world's security and future well-being depends upon the success with which the United States handles these foreign economic relations and administers its great economic and political power. Spectacular opportunities for progress exist, perhaps through a *pax Americana*, or a *pax Anglo-Americana*, if other methods fail.



PART V

COURSE OF INTERNATIONAL FINANCE



## CHAPTER 36

### COURSE OF INTERNATIONAL FINANCE, 1918-1929

**European Inflation After First World War.**—After the Armistice economic and financial conditions in Europe became progressively worse. Inflation was carried to such extremes that in some countries business came practically to a standstill. Conditions were so chaotic that, from the standpoint of non-combatants, the suffering of the post-war period was far more intense than that of the period of actual conflict. The huge expenditures of the belligerents were financed to a considerable extent by inflation of the currency. Most neutral nations also suffered from inflation, and were profoundly affected by the disarranged state of affairs throughout the world. By the end of the war, all the countries which had participated in the conflict and most of the neutral nations had abandoned the gold standard and were on an inconvertible paper-money basis, with inflated prices. This, however, was not the end of their currency troubles.

In time of war, governments have three principal ways of securing needed funds: taxation, borrowing, and inflation of money and credit. Taxes take time to levy and collect, while the money is needed promptly. Since it is difficult if not impossible to raise by taxation all the money necessary, government borrowings are resorted to. If the money borrowed comes from the savings of the public this is not inflationary. The public, instead of spending the money itself, turns the money over to the government to spend, and no inflation is involved.

During the first World War, however (and also during the second World War), governments borrowed not only the public's savings but in addition borrowed credit from the banks. In most countries, banks issued paper notes, or deposit credits, to

the government against government bonds. This type of inflation is very little different in its effects from direct inflation by the issuance of government paper money. This latter form of inflation—direct issues of government paper—was seldom availed of, but as a result of the former type of inflation commodity prices rose sharply, and in some countries during the early twenties went to fantastic heights.

The extent to which inflation prevailed in the different countries, particularly after the war, varied greatly. Although the Allied nations suffered severely, they suffered less from inflation than did the Central Powers. The United States, which did not enter the war until 1917, was the least affected by inflation. Nevertheless, between the spring of 1915 and the spring of 1920, the average of wholesale prices in this country increased by approximately two and one-half times. In Great Britain, wholesale prices more than trebled between 1913 and April, 1920. In France, during the same period, wholesale prices increased by almost six times, while in Italy the index number climbed to seven times the pre-war level.

Following peak levels in the spring of 1920, wholesale prices throughout the world showed sharp declines. The decline, however, was temporary in France and Italy, where inflation continued; French prices eventually surpassed even those of 1920 and continued to rise until the stabilization of the franc in 1926.

The inflationary experience of the Allied countries was mild in comparison with that of Germany, Austria, Russia, and Poland. In Germany the inflation was particularly extreme, and the mark declined in value until one trillion paper marks were the equivalent of one gold mark, worth about 24 cents in United States money. The mark was finally stabilized at this level in 1924. During the war, when the German Government used its credit-manufacturing power with relative moderation, the rise in prices was not serious. In the four years between 1914 and 1918, prices rose to something over twice the pre-war figure. The relatively moderate rise in prices during the war years, however, was followed by violent and erratic movements during the next half decade.

After the Armistice, the German Government continued to rely on the central bank, the Reichsbank, for funds. The government needed money to pay reparations and for other purposes, and consequently borrowed heavily. The loans to the government were in the form of paper bank notes, which were printed and issued in huge amounts. This policy of meeting expenses by the printing of paper money, disturbing enough in 1918, had catastrophic effects by 1923. The pace of government borrowing and resulting currency expansion became ever swifter until in 1923, after the Ruhr occupation by France, the increases assumed fantastic proportions. The war had introduced figures of tens of billions, but post-war developments produced quintillions.<sup>1</sup>

The gigantic increase in the volume of money in Germany was accompanied by sharp increases in commodity prices. The fluctuations in prices from one day to the next were tremendous, and merchants even adjusted selling prices several times during a single day. Before the basketfuls of paper money received for an article could be counted, the money would have lost a part of its value. Amid such chaos business became all but impossible. The savings of thousands of people were entirely wiped out, because the savings were in terms of money which came to have practically no value. Countless instances existed of persons who put their money in a bank or invested it in securities, only to find that while their 10,000 marks (about \$2,500) were still 10,000 marks, this amount would not buy a newspaper.<sup>2</sup>

The mark was finally stabilized in 1924, as noted below, at a rate of one trillion of the former paper marks, to one of the new so-called Reichsmarks, worth about 24 cents in American money.

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<sup>1</sup> The astronomical proportions of these figures make them difficult to read. Reichsbank notes in circulation increased from 22,188,000,000 marks at the end of 1918 to 113,639,000,000 marks by December 31, 1921, to 1,280,095,000,000 marks by the end of 1922, and to 92,844,721,000,000,000 marks on November 15, 1923. Deposits, which during the war and first years after the Armistice had not risen as swiftly as the other items, overtook the increases in note circulation during 1923, increasing from 13,280,000,000 marks at the end of the war, to 22,327,000,000 marks two years later, and to the enormous total of 129,552,597,000,000,000 marks by November 15, 1923.

<sup>2</sup> For further data relating to the war and post-war inflations, see John Parke Young, *European Currency and Finance*, Washington, D. C., Government Printing Office, 1925, Vols. I and II.

**The Problem of Currency Reform.**—The acute disruption resulting from the currency chaos made clear the need for a return to monetary stability. The international financial conferences held at Brussels in 1920 and at Genoa in 1922 recommended a prompt return to the gold standard; but little along this line was accomplished for several years. The disastrous uncontrolled inflation in central Europe, which shortly followed, emphasized the necessity of stabilizing currencies.

The gold standard was generally regarded at this time as the end toward which efforts should be directed. A considerable time elapsed, however, before the nations of the world finally returned to a gold basis, and it was a different kind of gold standard than that of the pre-war years.

The war had left in its wake many problems. In the first place there was the very large amount of depreciated paper currency outstanding. Furthermore, gold was very unevenly distributed, the United States having about half the world's monetary gold. European officials felt that their reduced gold reserves were insufficient to support a return to gold. Some persons feared that world gold resources were inadequate for a general reestablishment of the gold standard. Moreover, the unsatisfactory nature of the gold standard led some economists to urge that a managed currency system be adopted by the leading nations in place of gold.

A serious difficulty was the inflated price levels which prevailed because of the large amounts of currency outstanding. Even if the gold reserves of the countries had been as large as before the war, they still would not be ample to support all this new money at the old gold par. To retire some of the money would be expensive, and would also cause serious deflation, falling prices, and consequent depression.

The alternative to resumption of gold payments on the pre-war basis (which was out of the question) was devaluation of the gold unit, i.e., reduction of its gold content to a point in harmony with the currency's lower purchasing power. Devaluation, however, was extremely unpopular and was regarded as an admission of financial weakness by the government. The public, not understanding devaluation and that the depreciation



of the currency had already taken place, was greatly opposed to this step. Even though the necessity of devaluation was clear to currency students if the gold standard was to be restored, government officials found the question so delicate that in most countries they were unable even to admit devaluation as a possibility.

The uneven distribution of gold was regarded as a serious barrier to the proper functioning of the gold standard. At the end of 1924, the United States held about three billion dollars of gold, which was a large amount for that period—over half the monetary gold of the entire world. Most of this had come to America since 1914. Much the larger part of the remainder of the world's monetary gold was divided about equally between England and France. The United States received gold largely because this country had exported heavily to Europe during the war and after the war. In lieu of goods and services, large quantities of gold flowed to America in partial payment of purchases by Europe. In the space of about three years, the United States was transformed from a net debtor nation into a great creditor. The stability and relatively safe position of this country attracted millions in gold after the war for investment and safekeeping.

Another condition which caused economists to doubt whether the gold standard would function satisfactorily was the possibility of large and sudden capital movements. It was feared that, in the event of a return to gold, pressure would be placed on different currencies in order to transfer capital, and that demands for certain currencies, like runs on banks, would take place and interfere with domestic currency conditions. Subsequent experiences along these lines are noted below.

**Great Britain and Other Countries Return to Gold.**—The United States, which in 1917 had placed an embargo on gold exports and suspended gold redemption, returned to gold in 1919. During the next four years, the United States was the only leading country on a gold basis, and the dollar acquired a great deal of prestige; possession of dollars was much desired by persons in Europe and other parts of the world. Between

1924 and 1928, however, almost every important nation went back to gold.<sup>3</sup>

The German mark was stabilized and placed on a form of the gold standard in 1924, as arranged by the Dawes Plan. Currency stabilization in Germany was the turning point from chaos to reconstruction and subsequent prosperity for Germany, and for most all Europe.

Great Britain finally returned to gold in April, 1925, at the pre-war par of exchange, \$4.86 in United States money, and was immediately followed by several other countries. Since exchange rates had been below par preceding this event (\$4.77 immediately preceding), the effect of the return to gold was to make the pound more expensive in terms of foreign currencies, and therefore, to make British goods more costly to foreigners. The effects of this situation, expensive British goods, were much as would be expected; namely, it tended to discourage British exports. This was depressing to British industry, already troubled by post-war readjustments at home and abroad. A downward adjustment of prices, wages, and profits was necessary in order to make the pound worth the par value of \$4.86.

It was felt by some persons that a new and lower par, \$4.50, for example, would have been more in harmony with the prevailing price level in Great Britain, that this would have been easier to maintain and would have brought greater prosperity to the country.

The return to gold at the old par was strongly opposed by the British Federation of Industries and by the British economist, John Maynard Keynes. Keynes, who had originally advocated reestablishment of the gold standard, in 1923 urged the adoption of a managed paper standard. He believed that resumption of gold payments at the former par would create unnecessary unemployment, and that Britain's new position of

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<sup>3</sup> The post-war return to gold may be summarized as follows: Lithuania and Latvia adopted a gold standard in 1922; Germany, Sweden, and Hungary returned to gold in 1924; England, Holland, the Dutch East Indies, Australia, New Zealand, South Africa, Switzerland, and Austria in 1925; Finland and Belgium in 1926; Denmark, Czechoslovakia, Poland, and Italy in 1927; France and Norway in 1928. The only important nations which did not adopt gold in these years were Brazil, Spain and Turkey, which remained on an inconvertible paper basis, and China and Persia, which maintained a silver standard.

debtor to the United States would make it impossible for the gold standard to function with its pre-war smoothness even if gold payments were resumed at a reduced par of exchange.<sup>4</sup>

Subsequent experience convinced many economists that Great Britain made a mistake in returning to the pre-war par. Partly because of this action, British industry was in a state of chronic depression, with severe unemployment, until after gold was again abandoned in 1931. Had Great Britain pursued a policy of tighter money and deflation during these years, the country could probably have maintained the gold standard, but such a policy would not have added to domestic prosperity.

**France Returns to Gold.**—The currency situation in France after the war was quite different from that in Great Britain. With the outbreak of the war in 1914, the franc was detached from gold, but was pegged for the duration of the conflict, largely through British and American financial assistance. When the war was over, artificial support was withdrawn, with the result that the franc began to decline rapidly in the foreign-exchange markets. Furthermore, inflation in France continued for several years, commodity prices therefore rising higher and higher, and franc exchange falling continually lower. Expecting that Germany would pay the bill, France poured huge sums of money into the reconstruction of its devastated areas. As a result of these and other expenditures, the national budget was in a badly unbalanced condition, the deficits being met by inflation. The financial disorders in France and the weakening of the franc stimulated the wholesale outflow of French capital. This occurred during the years 1919 to 1926. French capitalists, desirous of maintaining their funds intact, transferred them to countries with stronger currencies. This outflow of capital, causing a strong demand for foreign currencies, pushed the

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<sup>4</sup>In February, 1925, Keynes wrote: "Those who think that a return to the gold standard means a return to these conditions (the pre-war currency conditions) are fools and blind. We are now the debtors of the United States. Their foreign investments last year were double ours, and their true net balance available for investment was probably ten times ours. They hold six times as much gold as we do. . . . A movement of gold or of short credits either way between London and New York which is only a ripple for them, may be an Atlantic roller for us." *Essays in Persuasion* (a collection of previous articles), New York, Harcourt, Brace & Co., 1932.

franc still lower in the exchange market. At the same time, the franc was a target for international exchange speculation, because of expected further declines. This was unsettling and tended to hasten the downward process.

To many persons France appeared to be headed for a currency debacle similar to that of Germany two years before. The budget was unbalanced and the deficits were being met by inflation. The franc had dropped in the exchange markets from about 19.3 cents in American money (the pre-war mint par) to approximately 2 cents by July, 1926. A National Union Ministry was formed on July 23, 1926, and Premier Raymond Poincaré emphasized that only through greatly increased taxation and strict governmental economy could the fall of the franc be arrested. His appeals were heeded by the legislature; high income taxes were voted, and the budget was balanced for the first time in thirteen years.

With fiscal order achieved, the franc rose in value to about 4 cents by the end of 1926, where it was stabilized on a *de facto* basis. This rise in value was not the result of a contraction of the circulation, but accompanied a slowing down in the rate of circulation as confidence returned, an increase in the demand for francs. The circulation actually expanded greatly after stabilization. In 1928, France officially returned to the gold standard, the gold content of the franc being fixed at the equivalent of about 3.92 cents. This act of devaluation was legal recognition of depreciation which had already taken place. With stabilization accomplished, the outflow of French funds was reversed, and capital began to return to France on a large scale. The gold reserve was built up and the Bank of France acquired large balances abroad as funds abroad were exchanged for franc currency.

The value at which the franc was stabilized, unlike that of the pound, was low in comparison to the price level and to costs within France. This was largely because foreign exchange depreciation had outrun internal depreciation. The low value at which the franc was stabilized was partly responsible for the flow of gold into France, and for the prosperity which followed. However, after the chaotic period in France, accompany-

ing the currency disorders, stabilization in itself would contribute powerfully to improved conditions. Although the British pound had been unstable, it had not experienced the extreme fluctuations, with the consequent disturbing effects of the French franc.

The new low value of the franc was easier to maintain than if a higher value had been selected. It aided French exports, which together with the return of French capital, helped the Bank of France to build up its foreign balances. The Bank of France paid out paper francs as it bought drafts in foreign currencies, the drafts being presented by persons who wished their capital back in France. The condition thus resulted that after stabilization the circulation continued to expand. This prevented the franc from rising.

**The Post-War Gold Standard—A Period of Currency Exploration.**—The gold standard of the nineteen twenties differed materially from the type which prevailed before 1914. After the war, European nations found themselves with greatly depleted gold reserves, as a result principally of the large European purchases abroad not offset by exports. Gold had been exported to buy necessities. Currency reform, therefore, had to contend with small gold reserves, and consequently was of a type involving economy in the use of gold. The term gold standard came to be applied to any kind of standard wherein the unit was in actual fact maintained at a fixed relationship to gold, regardless of whether it was backed by much gold or was redeemable directly in gold.

Before the war, gold coins were used freely in domestic transactions. This condition was believed by some persons to be an indispensable qualification of a full gold standard. During the war, however, gold disappeared completely from hand-to-hand circulation, driven out by the large amount of depreciated paper money. When the gold standard was restored after the war, in few countries did the government make gold coins available for general circulation. With the exception of the United States, in practically no country was it possible to obtain gold coins in exchange for paper money.

The so-called *gold-bullion standard* was adopted by England, France, and other countries. According to this standard, redemption in gold was possible only in large amounts, and the gold did not need to be in the form of coin but could be in gold bars.<sup>5</sup> This device obviously prevented gold from circulating internally. In the United States, no restrictions were placed on redemptions in gold coin, or upon the coining of gold, but during the war the American public learned of the greater convenience of paper money, and had no desire for gold coin when it was again available.

A significant aspect of post-war currencies was the widespread use of the *gold-exchange standard*. Employment of this standard was usually on a *de facto* basis, without the formal regulations typical of the pre-war gold-exchange standard. No hard and fast line could be drawn between the gold-exchange standard as employed after the war, and the regular gold standard as this standard came to be understood. The pre-war type of gold standard completely passed out of existence, although it continued in the United States until 1933.

The principle of the gold-exchange standard is, essentially, that the currency be maintained at a constant value in relation to gold through redemption, not in gold at home, but in drafts upon a foreign country in which gold is freely available. Formal arrangements may be determined by law, and may provide that a reserve be maintained abroad in the form of a deposit, payable in gold, and that drafts be sold by the government or its agency against this deposit, at prices which can fluctuate only within a narrow range, corresponding to the limits that would be set by the gold points if the full gold standard prevailed. This type of standard was installed before the war in the Philippine Islands, in Nicaragua, and in a few other countries.

The gold-exchange standard as employed by the European countries after the war was a loose arrangement wherein these countries built up large deposit balances in dollars in New York

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<sup>5</sup> In Great Britain, the Bank of England was obligated to pay out gold in return for legal tender money in amounts of not less than 400 fine ounces—about \$8,268 in American money of that period.

and in pounds in London. They stabilized exchange rates on these gold-standard centers by either buying foreign drafts with local currency, or selling drafts on these foreign deposits, according to whichever was required to maintain stability of exchange rates. They were thus in a position to enter the exchange market on either the demand or supply side. When necessary, the foreign deposits were often strengthened by means of loans or credits received from the foreign financial center. While these deposits abroad were not gold, but merely debts of foreign banks payable in gold, the government or its central bank, which had title to them, often counted them as gold, and sometimes even showed them as such in the balance sheet.

This system of deposited reserves put a heavy responsibility upon New York and London, where most of such deposits were kept. In 1931, when large withdrawals of funds from London took place, the strain became too great and Great Britain was compelled to suspend payments in gold, as noted below. After Great Britain left gold, the United States was subjected to large-scale withdrawals, which were successfully met, although the outflow of gold was at times large and threatened the American gold standard.

The post-war system of controlled exchange rates replaced the former system of automatic controls exercised by gold movements, and had profound effects, as subsequent experience showed. Formerly, when rates on a foreign country tended to rise, gold was exported to take advantage of the premium on exchange, and the supply of drafts was thereby increased as drafts were drawn against this gold. Conversely, if a foreign country's exchange tended to depreciate, gold was imported from such a country. The inflow and outflow of gold had important effects upon interest rates, monetary and credit conditions, price levels, incomes, and the flow of trade. An inflow of gold tended toward easy money and higher commodity prices, while an outflow tended toward tight money and lower prices. This is explained in previous chapters. It was gold movements and their effects which tended to maintain internal price conditions of the different countries in harmony with each other as determined by the fixed exchange rates.

When the above semi-automatic forces were replaced by the system of controlled exchange rates, and when internal credit policies were not guided by the condition of the exchange market and monetary reserves, but were determined according to domestic needs, or sometimes determined without reference to any carefully considered program, strains developed, particularly from the standpoint of the maintenance of fixed exchange rates and the gold standard. Internal credit and price conditions were not allowed to be determined by gold movements, and thus became out of harmony with established exchange rates—the value of a country's currency to foreigners. The internal value of the currency became out of harmony with the external value. As a result of the lack of equilibrium between demand and supply at the established rate, some currencies were under continuous pressure.

Countries thus had to choose between pursuing the aim of fixed exchange rates, and the consequent continued adjustment of internal conditions to such fixed rates, or the aim of stable internal economic conditions, even though this at times meant unstable exchange rates. Most countries chose the latter objective of internal stability, with as much external stability as practical. The currency systems of the nineteen twenties, wherein domestic currency and credit policies were largely divorced from foreign exchange and gold movements, marked a beginning of the later policy of definitely placing first emphasis upon internal conditions, even though this meant fluctuating exchange rates. But first the world was to suffer from unprecedented economic instability, deflation, depression, and a currency and exchange cataclysm.

**Foreign Lending and Balance of Payments During Twenties.**—During the post-war years a very large amount of international lending took place, particularly on the part of the United States. For several years this country was loaning to foreigners at the rate of between one and two billion dollars a year. These loans provided foreign countries with a generous supply of foreign exchange without having to export merchandise or render services. The countries were thereby enabled easily to maintain



exchange rates in spite of heavy imports and an unbalanced condition in foreign payments and receipts. Foreign loans, by providing for deficits in a country's foreign payments, thus tended to conceal strains, and to prevent maladjustments from asserting themselves, or necessary adjustments in reciprocal demand from being made so as to bring equality between debits and credits.

American exports were financed to a large extent by American loans to foreigners, since imports into America were insufficient to pay for the large outflow of goods. The inflow of gold also helped to finance exports. America, however, was a substantial creditor, and as such should have been receiving large amounts of goods and services from abroad as interest payments. The American high tariff policy, discussed in another chapter, discouraged the sale of foreign goods to America, and thereby contributed to the maladjustment and to the inflow of gold. It interfered with the needed expansion of exports by other countries in their trade with America.

German reparations, a heavy burden upon the German nation, were transferred to the creditors partly by means of liberal borrowings from abroad instead of by the exportation of German goods. So long as debtor nations could without much difficulty secure whatever short-term and long-term credits they needed from foreign countries, exports and imports did not need to balance, and the world's economic life to outward appearances proceeded fairly smoothly. Currencies and foreign-exchange rates appeared stable. When the collapse finally came, and foreign lending ended, exchange rates were under pressure and depreciated. Loans were not available to take up the slack in the foreign accounts of countries that were current debtors. Moreover, internal economic disorders intensified foreign exchange, or external instability. The problem of external stability versus internal stability, and of how to reconcile these two objectives, appeared in clear outline.

**German Reparations.**—In modern times large indemnities have been paid by France, China, and Germany. A payment of 5,000,000,000 francs (about one billion dollars) was collected by Germany following the Franco-Prussian War of 1871. Ger-

man troops occupied France until this sum was paid. Following the Sino-Japanese War of 1895 Japan collected from China an indemnity of 200,000,000 taels (about \$170,000,000 at that time).

When the United States entered the first World War in 1917, it declared against the principle of indemnities. However, upon the defeat of Germany and the other central powers in 1918 the Allied nations did not concur in the position taken by the United States. France, whose territory had been ravaged, needed financial help for reconstruction.<sup>6</sup>

In the treaty of Versailles Germany was forced to accept responsibility "for causing all the loss and damage to which the Allied and Associated Governments and their nationals have been subjected as a consequence of the war imposed upon them by the aggression of Germany and her Allies." Germany was also required to agree to pay the entire war debt of Belgium and to "make compensation for all damage done to the civilian population of the Allied and Associated Powers and to their property during the period of belligerency of each. . . ."

At the Peace Conference in 1919 the Allied nations were unable to agree upon the amount of the bill for reparations to be presented to Germany. Extravagant sums were proposed, far beyond Germany's capacity to pay. One group wanted the amount left elastic, so that as Germany recovered from the war, reparations could be adjusted. The treaty finally provided that a Reparation Commission be established and that this commission determine what the total bill was to be and how it was to be paid.

The Reparation Commission accordingly announced in April, 1921, that Germany should pay 132,000,000,000 gold marks, the equivalent of \$32,000,000,000. This was in addition to the Belgian war debt. Serious students knew that this enormous amount would never be paid. Germany was to begin payments immediately at the rate of \$750,000,000 a year.

Germany paid upon this basis until 1923, but with the greatest of difficulty. She paid in cash, in coal, in ships, in railway equip-

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<sup>6</sup> For a discussion of the war debt situation see Chapter 23.

ment, in livestock, and even in works of art. In order to get the necessary money with which to buy foreign drafts to be turned over to the Allied powers, Germany printed quantities of paper marks. The consequences of this inflation are well known. The mark circulation rose to the unpronounceable figure of about 500,000,000,000,000 billions at the end of 1923. The value of the mark—24 cents before the war—declined accordingly to a point where it took 100,000,000,000 marks to buy a newspaper. Economic conditions in Germany by this time had become critical. The chaos was extreme and business came almost to a standstill.

On January 9, 1923, Germany was declared in default on reparations. France and Belgium promptly (January 11, 1923) marched their troops into the Ruhr valley and took possession of this rich part of Germany. Great Britain had vigorously opposed such a drastic measure. Sentiment in the United States was largely with Great Britain, the public feeling that Germany was being pressed too hard. France, on the other hand, felt that Germany was not making a sincere effort to pay. Germany was desperate over the situation, but no action was possible on her part.

Throughout all Europe conditions were greatly disturbed, both economically and politically. Inflation and its severe hardships had ravaged most of the countries. Bread riots and other forms of violence reflected the intense suffering and low morale of the people. The post-war period undoubtedly saw more real suffering among the non-combatants than the period of actual conflict.

The United States during these troublous times had withdrawn from European affairs, with the result that Germany was bitter toward us. The idealism of President Wilson seemed to her merely empty words. France charged us with deserting Europe at a critical stage. We had come over, taken the glory of winning the war, and gone home without helping to set things in order. Great Britain felt that we should throw our influence with her in her efforts for moderation. In the United States, political squabbles kept us from taking any active part in solving these international problems so intimately related to our

own well-being. As soon as the war was won we seemed to think our job completed, and that the objectives for which we had fought, "making the world safe for democracy," would be attained automatically.

The United States, it has been noted, early declared against indemnities in principle, and at the Peace Conference refused to accept a share of reparations. From our standpoint, therefore, the reparation problem had always been distinctly a European problem. We had no member on the Reparation Commission although we did have an observer who sat with it.

In December, 1922, Secretary of State Hughes made a speech in New Haven in which he declared that the reparation problem was an economic and financial one, and should be taken out of the hands of diplomats and politicians and turned over to a group of experts who should decide what Germany was able to pay and how she might pay.

Europe, looking anxiously to America, seized upon this statement of our Secretary of State as an offer of help. America at last was willing to cooperate, provided reparations were taken out of politics, a condition not easy to satisfy. As the failure of the Ruhr expedition became apparent, discussion between the United States and Europe led to the appointment of the so-called Dawes Committee of experts by the Reparation Commission. The three American members were private citizens but served with the blessing of our government, which assisted in their selection.

**The Dawes Committee.**—Representatives of the different powers assembled in Paris early in January, 1924, and promptly elected Charles G. Dawes, of the United States, Chairman. One of the main problems was to determine how the resources of Germany could be availed of to pay the Allied nations. Conditions in Germany were chaotic at that time and an important immediate problem was the stabilization of the German currency and the rehabilitation of the country generally.

After two or three months of intensive work the Committee made its recommendations, which became known as the Dawes Plan. The Dawes Report wisely did not attempt to determine

the total amount of reparations that Germany should pay, but undertook to decide merely what Germany could pay each year in the immediate future. The Plan provided for small payments the first year or two, working up to about \$625,000,000 the fifth year, 1929, which was to continue indefinitely. The Plan also provided that a portion of the payments should be made in kind, that is by handing over actual goods. This, it was thought, would facilitate the transfer of the payments from Germany to the Allied nations. The transfer problem received serious attention, many persons feeling that the amounts Germany was required to pay were greater than could be transferred to the other nations without causing a breakdown of foreign-exchange rates. To deal with this contingency, provision was made that in the event that the money could not be transferred without causing the mark to depreciate, as marks were offered for francs, pounds, etc., the money should be held within Germany, accumulating to the credit of the Allied nations.

In order to assure an adequate supply of funds within Germany, certain revenues were earmarked for reparation payments. Several foreign commissioners were appointed to supervise matters. The Plan also provided for the reform of the German Reichsbank and the stabilization of the currency.

The Dawes Report was accepted by Germany and the other nations involved, and promptly put into force in the fall of 1924. General recovery in Germany and throughout Europe followed rapidly. In order to initiate the Plan, Germany borrowed about \$200,000,000 in the world's market. The fact that Germany was able to float a loan of this size indicated the extent to which her credit was restored.

**The Young Plan.**—The Dawes Plan was recognized at the time as a temporary measure for two reasons. It provided no end to reparations, the total having been left indefinite in the interests of harmony, and it set up an elaborate system of supervision over Germany's financial affairs. This was offensive to German pride; in fact, reparations themselves were greatly resented. Finally, late in 1927, the Commissioner of Reparations, an American, said it was time Germany be told what was ex-

pected of her and that she be allowed to run her own affairs. The Allied nations and Germany agreed that a new committee be established to prepare a final solution to reparations.

Accordingly, the so-called Young Committee was appointed and met in Paris in February, 1929. The Chairman of this committee was Owen D. Young, an American, who had also been a member of the Dawes Committee. As a result of this new conference, reparation payments were considerably scaled down, and were to continue until 1988, the average yearly payment amounting to \$474,000,000.

The Young Plan had scarcely begun to function when business depression seized the world. Germany's revenues declined, as did the country's foreign trade. German finance began to creak under the load. Germany had borrowed heavily abroad, especially in America, in the years following the Dawes Plan, and now had large foreign payments to make in addition to reparations. These foreign borrowings amounted to between four and five billion dollars, about half of which, unfortunately, were repayable upon short term. Much of the money, however, was invested in long-term undertakings, both public and private. The merchant fleet was reconstructed, many industries modernized, and towns carried through programs of public improvements.

When the foreign creditors, financially involved at home and nervous over Germany's condition, asked Germany to remit, she was unable to meet their demands. She exported some of her gold reserve, but this did not suffice. Great Britain, to her own undoing, loaned Germany money in the attempt to hold things together.

## CHAPTER 37

### COURSE OF INTERNATIONAL FINANCE, 1929-1942

**The International Financial Collapse of 1929-1933.**—The restoration of the gold standard throughout the world during the nineteen twenties, and the new economic structures set up, involved several unstable elements, and were followed within a few years by a general abandonment of gold, by the most severe and extensive depression and economic disorders the world had experienced.

After the war a realignment of political boundaries and the creation of new states had altered radically the accustomed flow of trade. In many countries tariff and other barriers were raised to unprecedented heights, with consequent disturbing effects upon trade, and contributing to the unsettlement in the balance of payments. In addition, huge transfers of capital were taking place, with profound effects upon the movements of goods and upon countries' foreign accounts. Gold, partly as a result of these conditions, was very unevenly distributed. At the same time, the monetary and fiscal policies of most nations were not guided by gold or the international economic situation, but were based largely upon domestic considerations. Foreign lending, moreover, covered up maladjustments in trade balances, and concealed the underlying disequilibrium. Speculation in most countries had become rampant and, coupled with inflation, added to the instability. This was the background for the world-wide events which began late in 1929.

The world realized that perhaps something was wrong when the stock market in America suffered drastic declines beginning in October, 1929. Prior to the stock market crash, business throughout the world had begun to slow down, and to careful observers strains were apparent. Conditions in America and

elsewhere soon went from bad to worse, and the entire world became engulfed in unprecedented depression, financial and economic collapse. The price levels of all countries declined drastically as can be seen in Figure 12 on page 638. Social and political disorders grew out of the economic disturbances and the widespread discontent. Autarky and economic nationalism forged ahead. The economic upheaval made possible the progress of the Nazi system and German aggression.

**The Credit-Anstalt Affair.**—Early in 1931 there were signs of recovery, but in May, 1931, events took a sharp turn for the worse. The occasion for the relapse was the failure, on May 11, of the prominent Austrian Credit-Anstalt, a Rothschild-controlled bank in Vienna; the condition of the bank had previously been beyond suspicion. The failure was precipitated by a panic which followed the writing down of the bank's assets as dictated by the altered financial situation and the decline in values. The bank, in the spring of 1931, had revalued its assets, consisting largely of securities and loans. Austrian depositors, worried by the apparent change in the bank's condition, demanded their funds, with the result that a run on the bank developed, and forced suspension of payments.

In order to understand the failure of the Credit-Anstalt, it is necessary to understand the European political situation existing in the spring of 1931. France was opposing vigorously the Anschluss, or customs union, between Germany and Austria. In order to prevent the consummation of this customs union, France brought financial pressure upon Austria, which contributed to the collapse of the Credit-Anstalt. This was followed by a train of other troubles in a financially unstable Europe, finally involving the entire world.

The Austrian Government promptly came to the aid of the Credit-Anstalt, but found difficulty in securing the funds needed to cover the deficit of the bank. The government arranged to issue Treasury bonds to obtain the needed money. The French authorities had agreed in May to participate in the loan, but subsequently stated that they would do so only provided Austria abandon plans for the customs union. France did not desire any consolidation of Germany and Austria. The Austrian Govern-



ment, however, was not willing to abandon the customs union. To protect Austria's creditors and the solvency of the country, the Bank of England came to the rescue with a credit of £5,000,000. The Bank for International Settlements also aided. The customs union was not popular in England, and the motives behind the Bank of England's action were apparently financial rather than political. In September a crisis in London forced the Bank of England to request payment.

In the "standstill" agreements (*Stillhaltung*), which followed the troubles in Austria, foreign creditors of the Credit-Anstalt and other Austrian banks accepted a two-year moratorium on their claims. The purchase and sale of bills of exchange was placed under control of the Austrian Government in order to limit exchange fluctuations; this inaugurated exchange control in Austria.

**German Financial Crisis of 1931.**—Financial affairs in Europe continued to grow worse. American banks began to withdraw funds from Germany and central Europe as a result of the trouble in Austria. British, Swiss, and Dutch banks soon did the same. The German Reichsbank was compelled to part with large amounts of gold in order to maintain the stability of the mark. The Reichsbank received support from the Bank for International Settlements, the Bank of England, Federal Reserve Banks, and the Bank of France.

The support, however, was inadequate, and the short-term credits granted were soon exhausted. The Bank of France was in a position to extend additional credit, but as a condition demanded that Germany abandon the customs union and the construction of a cruiser. This Germany was unwilling to do. On July 13, 1931, the important German Darmstaedter und National Bank failed, the second largest bank in Germany. This failure was followed by a series of important bank failures throughout central Europe and elsewhere. As a result of the crisis Germany stopped payment on her external short-term credits, as arranged in "standstill" agreements, and instituted control over foreign exchange operations.

In an effort to relieve matters and halt the world depression, made more severe by the crisis in Europe, President Hoover,

on June 20, 1931, announced his proposal for a one-year moratorium on reparations and war debts. This bolstered confidence temporarily, but did not get at the root of the trouble, as subsequent experience showed. The crisis had assumed serious proportions, and conditions throughout the world continued to be grave.

From central Europe the scene of crisis shifted to London, resulting in the collapse of the pound, with tremendous repercussions. Then eyes turned on the United States, and this country was subjected to heavy pressure. It was able, however, to stand against the tide and maintain the dollar on a firm basis, paying all foreign creditors as demanded. Subsequently the United States deliberately took the dollar off the gold base, by choice of the new Administration and not because the gold standard could no longer be maintained.

The part played by French politics in the international financial crisis has been the subject of debate and criticism. The evidence is strong that France was using financial weapons to accomplish political ends, and contributed much to the financial and economic chaos which gripped the world following 1929. It is also undoubtedly true that France did not realize, at the time, how great the consequences were to be, and that she herself would later be engulfed in the financial maelstrom, and subsequently become the victim of German aggression which was furthered by the economic chaos.

Financial conditions throughout the world were already disordered and unhealthy, so that French policy cannot be held responsible for all that subsequently happened. France is condemned harshly by Paul Einzig in his book *Behind the Scenes of International Finance*. He says, "the financial warfare conducted by France in order to acquire political power over Europe has largely contributed to the development of the economic depression since 1929, and has been the direct cause of its accentuation during the second half of 1931 into a crisis without precedent."<sup>1</sup> He presents a severe indictment of French foreign policy.

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<sup>1</sup> Paul Einzig, *Behind the Scenes of International Finance*, New York, The Macmillan Co., 1932, p. v.

**Hoover Moratorium.**—The world depression became increasingly severe, and many people believed that reparation and war debt payments were somehow a factor. Suddenly, in June, 1931, in order to help relieve the situation, President Hoover announced that the United States would postpone for one year all payments of interest due it on the war debts, provided the European nations would similarly postpone all their intergovernmental payments. The Hoover moratorium was soon an accomplished fact, taking effect the first of July, 1931. France was very hostile to this move, but found no other course possible than to cooperate. France knew that it was much easier to allow Germany to stop paying than to get her to start again, and that if Germany once stopped she would probably never resume her payments.

The Lausanne Conference of 1932 was called to determine what should happen when the Hoover moratorium expired. The agreement finally reached at this conference was that Germany should deliver \$714,000,000 in German Government bonds to the Bank for International Settlements as complete payment of reparations. After three years the bank should market these bonds in amounts and in such manner as it saw fit. The nations, however, agreed not to ratify this arrangement until a "satisfactory settlement" had been reached with the United States regarding the war debts. When the moratorium expired, neither war debt nor reparation payments were resumed, with the exception of the small payments due the United States by Finland, and a few so-called token payments by some of the other debtors.

The moratorium did not deal with the source of the trouble, and the depression continued to deepen.

**Britain Leaves Gold.**—From Vienna and Berlin, the panic spread to London. It was known that Great Britain had made extensive loans in Germany and central Europe. As a result of the financial crisis on the continent, many of these loans had become frozen. At the same time, continental countries had large amounts of money on deposit in London, which could be withdrawn upon short notice. The position of London was thus the occasion for uneasiness.

After the British return to gold in 1925, the Bank of England had continued to maintain a rather slender gold reserve, equal on the average to some \$600,000,000. The funds that foreign financial institutions had on deposit in London in 1931 were well in excess of this amount. French banks were large holders of sterling balances, and began to withdraw them as did other foreign banks. London banks had nearly £100,000,000 in Germany, which were now frozen and unavailable.

Rumors were spread that London had lost heavily in the Austro-German crisis, and was in trouble. An international run on London developed, which soon assumed large proportions. Funds were withdrawn in great amounts, as fear spread that the pound was in danger of collapse. The withdrawals of deposits from London were due not only to the fear of impending disaster, but also to the necessity of meeting runs which had developed in other centers, and the desire to maintain liquidity.

In an attempt to check the run, the Bank of England and the British Government borrowed \$650,000,000 from the United States and France.<sup>2</sup> This, however, was soon exhausted. The Bank raised its discount rates to 3½% on July 23 and then to 4½% a week later. In the period between April and September, the Bank paid to foreigners the equivalent of over a billion dollars. Payment was made largely out of balances which the Bank held abroad, or borrowed abroad, rather than by the exportation of gold. The exportation of gold amounted to about \$160,000,000 and took place in July. On September 21, the Bank of England suspended gold payments, and the country thereby left the gold standard. The discount rate was on the same day raised to 6%. The pound promptly depreciated in the foreign-exchange markets.

France was criticized in connection with the collapse of sterling, in that, as conditions in London became critical, France refused to lend aid until the last minute when it was too late. France, it is contended, did not desire to bring about the col-

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<sup>2</sup> Of this amount, \$125,000,000 represented a credit extended to the Bank by the Federal Reserve Banks. An equal amount was loaned by the Bank of France. The remaining \$400,000,000 was loaned the British Government by private lenders in the United States and France.

lapse of the pound, since this would also damage France, but wished to see London weakened and then supported by France for a price. In Great Britain it was assumed that the Bank of England and the British Government could obtain almost unlimited support from the United States. The United States, however, replied that it could lend support only in conjunction with France. The United States did not wish single-handed to attempt to sustain the pound. Soon matters were out of bounds, and French support proved too late.

British suspension of gold payments was a tremendous shock to the rest of the world. The immediate result was to cause a considerable number of other countries also to leave gold, countries that maintained large balances in London as reserves for their currencies, which were thus dependent upon the pound. The countries which suspended gold payments following British suspension included Denmark, Norway, Sweden, Finland, India, Colombia, and Bolivia. In several other countries the governments instituted foreign-exchange control to prevent depreciation. These countries included Austria, Greece, Czechoslovakia, and Italy. Several countries had left gold prior to Great Britain—Argentina in December, 1929, Australia early in 1930, and New Zealand at about the same time. In July, 1931, exchange control had been put into effect in Germany, Hungary, and Chile. Within a few weeks after British suspension less than half the world remained on gold.

The departure of Great Britain from gold with its wide repercussions, threw the world's exchange rates into disorder, and was the beginning of the extensive currency chaos which had profound effects upon the already disturbed economic and social conditions throughout the world.

**United States Meets Gold Runs.**—After England left gold, rumors were spread that the United States would be next. The position of New York was similar to that of London in that New York held very large amounts of deposits owing foreign countries. In addition, foreigners possessed large sums in bills and other short-term American credits, as well as American stocks and bonds which could be converted into cash. The

United States, however, had a huge gold reserve, ample to cover all conceivable withdrawals.

On the other hand, if heavy withdrawals of gold should take place it was feared that a financial panic might result in America, since the country was in the throes of severe depression. While America held sizable amounts of short-term credits abroad, most of these were either frozen in Germany, or were in London and could not have been withdrawn except at a material loss because of the depreciation of the pound.

As fears regarding the dollar grew, funds were withdrawn by Europe with the result that exchange rates for dollars remained below the gold export point. Gold began to pour out of New York, and during the six weeks' period following suspension of the gold standard by Great Britain, the United States lost \$730,000,000 of gold.<sup>3</sup> The outflow of gold was the largest ever experienced by any country at any time during a similar period. Of the above amount of gold, \$415,000,000 was not actually exported, but was earmarked for foreign central banks and remained at the Federal Reserve Bank of New York; it was, however, effectively lost to America.

At this juncture, France began to exert financial pressure upon the United States to reenforce political negotiations which were under way. France held large balances in New York, and was the principal recipient of the gold exported. After France had reestablished the gold standard in the late twenties, her capital abroad began to return to France. The Bank of France's foreign balances had thus mounted as French capital abroad was presented to the Bank for repatriation. To prevent the franc from rising, or the rates for foreign currencies from falling, the Bank bought large amounts of foreign bills. The Bank paid francs to the French owner of the capital who wished it repatriated.<sup>4</sup> In this manner France came to possess large balances in

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<sup>3</sup> *Federal Reserve Bulletin*, November, 1931, p. 603.

<sup>4</sup> It will be noted that much of the capital did not really return to France, but that the ownership was merely transferred within France, the Bank becoming the new owner and paying for it by an inflation or expansion of francs. This inflation was possible without causing a serious rise in prices because of an increased demand for francs, which was reflected in a slowing down of the former rapid turnover or velocity of currency, which had been due to the reduced demand and had accompanied (and helped to cause) the depreciation, and also because of the expansion of business.

America, although some of the money had been withdrawn in gold.

In October, 1931, Premier Laval came to Washington to discuss with President Hoover certain problems, particularly the matter of reparations and war debts, payments on which were then suspended for one year under the Hoover moratorium. France had been taken by surprise when in June Hoover had announced this country's willingness to postpone debt payments provided reparations and other intergovernmental payments were also postponed. France, knowing that if Germany once stopped paying, it would be difficult to induce her to begin again, was very much opposed to Hoover's proposal; also irritated that France had not been consulted. Nevertheless, in view of the critical financial situation in Europe and world sentiment, France had been unable to refuse to agree. It was this situation, and what was to happen after the year's moratorium expired, that France wished to discuss with the United States.

In the middle of October, about the time that Premier Laval was leaving Paris for Washington, the Bank of France notified America that unless its balances in New York were guaranteed as to the rate of exchange, the Bank would have to withdraw them. The Bank also asked that higher interest rates be paid upon the official balances in New York, and suggested that the Federal Reserve Bank rate be raised to  $4\frac{1}{2}\%$ . These proposals were made by the Deputy Governor of the Bank who had arrived in America shortly before. The United States was at this time, it will be recalled, in the throes of unprecedentedly large withdrawals of capital and huge outflows of gold. The demands of France were, nonetheless, all refused. The attitude of New York was that the large French balances—about \$600,000,000—were an unstable element in the American financial picture, and that this country would be better off without them. The United States did not take kindly to attempts at dictation from abroad.

The United States placed no hindrances in the way of the withdrawal of funds by foreigners, and soon the outflow abated. The world was convinced that the American dollar was strong, and was not likely to follow the pound and other currencies

that had left gold. Soon the tide turned back toward America, and gold was imported from abroad.

In May, 1932, as the world depression continued to become more intense, renewed withdrawals of capital from America took place, and again large amounts of gold left the country. It was feared that the dollar could not withstand the strain of this second gold run. However, Federal Reserve authorities, watching the reduction of foreign balances in America, were of the opinion that the country was in a position to pay all foreign depositors on demand, and boldly paid out gold as it was wanted. The run was again halted, and again confidence in the dollar was reestablished. As a result, the flow of gold once more turned toward America. The world believed that America was the safest place in which to keep capital, and this country's gold reserves continued to mount during the last half of 1932. By the end of the year the gold reserve was larger than it had been at any time since the fall of 1931, following the departure of England from gold.

**United States Abandons Gold Standard.**—Meanwhile, serious banking difficulties were developing in this country. These were climaxed on March 4, 1933, when New York followed the example of numerous other states and declared a state-wide bank holiday. On March 6, the newly inaugurated President Roosevelt proclaimed a national bank holiday, and suspended all redemption in gold. On March 10 he forbade the exportation of gold from the country except under license. Gold reserves at that time were larger than they had been for over a year and a half.

The dollar remained fairly stable in the exchange market between March 6 and April 19. On April 20 the President prohibited the export of gold except as authorized by the Treasury Department with the approval of the President, with a few exceptions. This indicated that the dollar was not to be maintained at par, and it depreciated rapidly in the exchange market. By the end of the year the dollar had declined greatly in terms of gold and gold standard currencies. The French franc rose from about 3.9 cents in January, 1933, to about 6.2 cents in Decem-



ber. Other gold currencies also rose in the same proportion. The depreciated pound during the same period rose from about \$3.35 in January, to \$3.43 in March, and to \$5.12 in December, 1933, thus being above the former par. In November, 1932, the pound had declined to a low of about \$3.14.

In an attempt to raise the commodity price level and thereby facilitate economic recovery, President Roosevelt, on October 22, 1933, announced in a radio address that the government would begin buying gold.<sup>5</sup> The gold-buying program was accordingly begun on October 25. The Reconstruction Finance Corporation, acting for the government, agreed to buy all foreign or newly mined American gold at prices determined from time to time. On October 24, the day before gold-buying operations were begun, the price of gold in the London market was the equivalent of \$29.74 an ounce, compared with the United States mint price of \$20.67.<sup>6</sup> In other words, \$29.74 in American money was required to purchase enough British pounds to buy one ounce of gold in London.

The initial gold-buying price on October 25, was \$31.36 per ounce. During the first week of the program, new prices were announced each day: \$31.54 on October 26, \$31.76 on the 27th, \$31.82 on the 28th, and so on. Thereafter, prices were raised at irregular intervals until the price was \$34.45 on January 16, 1934. On January 31, 1934, the dollar was officially devalued, the price of gold being fixed at \$35 an ounce. The new dollar thus represented 13.71+ grains of fine gold, or 59.06% as much as the old dollar of 23.22 grains. Foreign-exchange rates promptly adjusted to this level. The dollar has since been kept at this level in terms of gold.

After devaluation the United States received large quantities of gold. This influx was due partly to the high price paid in America, but later was the result principally of the heavy flow of capital to America. Capital came to seek safety from the

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<sup>5</sup> The so-called Thomas amendments to the Agricultural Adjustment Act of May, 1933, gave the President broad powers over the currency, including that of reducing the gold content of the dollar up to a maximum of 50%.

<sup>6</sup> The world gold market centered in London. In going off the gold standard, England did not place an embargo on exports of gold, but merely suspended redemption of its currency in gold. Hence the London gold market was not destroyed.

economic and political troubles of Europe, and also to take advantage of recovery and the attractive investment possibilities in the American market.

**The Gold-Bloc Countries.**—After the United States abandoned gold, the European countries that remained tied to gold, notably France, Italy, Switzerland, Belgium and Holland, became known as the gold-bloc countries. These countries soon found their position extremely difficult. The currencies of the gold-bloc countries were at a premium throughout most of the world, so that their goods were expensive to foreigners. For example, the French franc was high in price abroad, in relation to its former level and in relation to its purchasing power within France. French goods, therefore, became so expensive that France found difficulty in selling to the rest of the world. Costs in France thus had to be reduced. The process of adjusting prices downward was very depressing, and the cause of social and political troubles.

The gold-bloc countries, subjected to severe deflationary pressure and declining price levels, nevertheless, vigorously declared their intention of remaining upon gold. Even though their currencies were out of harmony with those of most of the world, in terms of gold, and capital was leaving the countries seeking safety abroad, the possibility of devaluation was repudiated.

One of the reasons that these countries were so determined to stay upon gold at the established level was that the public had fresh memories of the previous currency troubles, inflation and devaluation. To them devaluation meant a destruction of their savings and other values. The situation was, of course, not parallel, inasmuch as the earlier devaluation was merely legal recognition of depreciation which had already taken place. A further devaluation of the gold unit now, to bring exchange rates into line within internal values, did not necessarily mean subsequent internal depreciation or inflation. It meant, instead, an effort to prevent a further fall in prices, or appreciation of the value of the unit. In most of the gold-bloc countries, however, devaluation was so unpopular that it was a political impossibility, at least for the time being.

Conditions became more and more critical, and the reserves behind these currencies were subjected to increasing pressure as foreign capital was withdrawn or as domestic capital was transferred abroad. The flight of capital went steadily forward in spite of government controls aimed to prevent it. Internal conditions, both economic and social, were disturbed as prosperity in these countries failed to return. To economists it became clear that eventually revaluation must take place.

One by one the gold-bloc countries were finally forced to revalue their currencies. Belgium, in March, 1935, was the first to leave the ranks, when the belga was reduced from .209211 grams of fine gold (established October 25, 1926) to .150632 grams. Prior to devaluation the belga was worth about 23.3 cents in New York, whereas afterwards it fell to about 16.9 cents, in line with the new gold content.

**France Devalues.**—From August 7, to September 25, 1936, the Bank of France lost \$320,000,000 of gold, principally to the United States and England. On September 26, the gold standard was virtually suspended in France as a result of emergency measures. A special session of Parliament was summoned and, by law of October 1, suspended the gold standard law of June 25, 1928. This earlier law had fixed the content of the franc at 65.5 milligrams of gold .900 fine. The new law authorized the government to fix the gold content of the franc at between approximately 65.6% and 74.8% of the previous amount. Prior to devaluation, exchange rates in New York were about 6.6 cents per franc. The franc, however, was not worth this much on the basis of its internal purchasing power. After devaluation the rates declined to about 4.6 cents, which was in closer harmony with the internal value of the franc. Soon after devaluation, however, prices rose sharply as can be seen in Figure 12. As the French gold reserve was written up in value in accordance with the new law, a portion of the profit was set aside, as in the case of the United States, to establish a stabilization fund for the purpose of controlling exchange rates.

A significant aspect of the French devaluation was the accompanying Tripartite Currency Agreement between France, Great

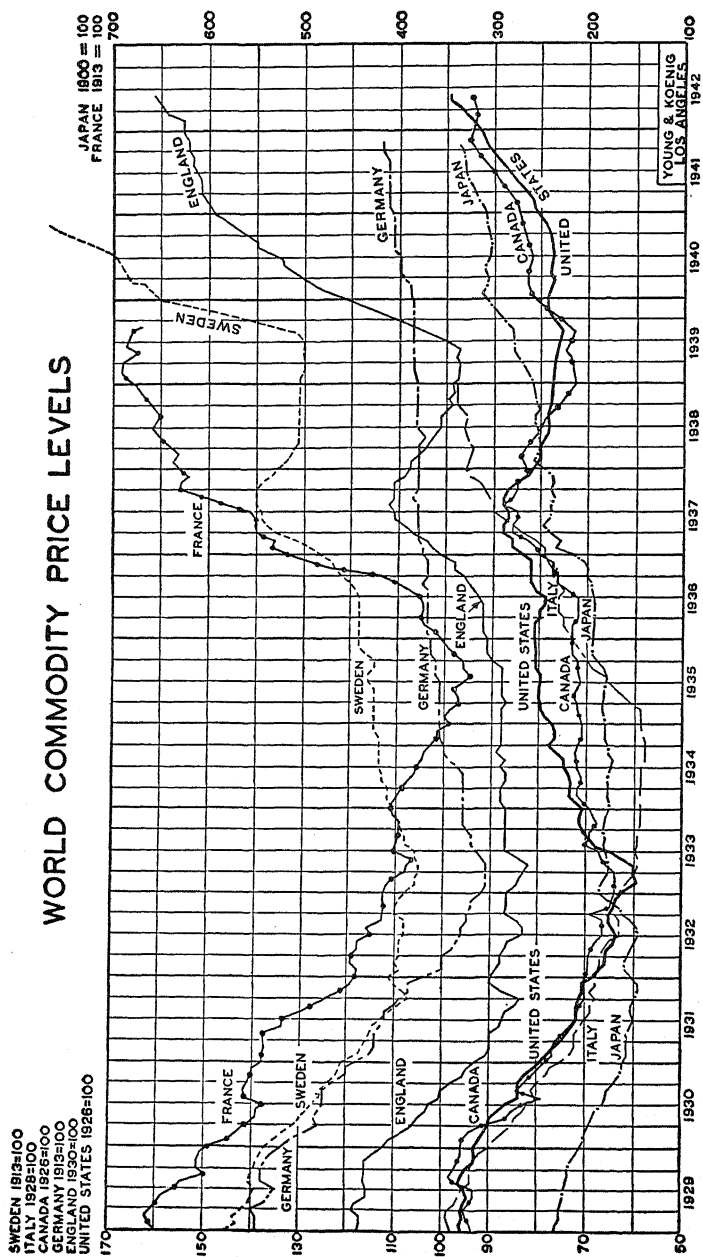


Figure 12. World Commodity Price Levels Since 1929

Britain, and the United States, announced September 25, 1936. According to this so-called "gentlemen's agreement," these countries agreed to cooperate in the stabilization of their currencies. Without this accomplishment to present to the French public, it is improbable that the French Government would have been able to have arranged the greatly needed devaluation without serious internal difficulties. This Tripartite Agreement, or declaration, is discussed in Chapter 31.

Devaluation did not mark the end of France's troubles. France struggled with a comprehensive social reform program, as well as with international difficulties. This situation created nervousness and caused capital to leave France. Since confidence was not restored, French capital abroad did not return as was the case following the former stabilization. The return of capital before had helped to strengthen the franc. The budget continued unbalanced, and an excess of imports put pressure upon exchange rates.

During the spring of 1937 the franc was again under heavy pressure, and between June 1 and 28 gold losses of the Stabilization Fund and of the Bank of France amounted to about \$350,000,000. On June 30, Parliament gave the government decree powers, and the same day a decree was issued, effective July 1, removing the previous legal limits to exchange fluctuations as established by the law of October, 1936. The franc was then allowed to sag, and in the latter part of 1937 declined to about 3.3 cents. The Tripartite Currency Declaration, however, continued in force, and communications from America and Great Britain to the French Minister of Finance reaffirmed the arrangement. Late in 1937 the position of the franc strengthened, and gold flowed from America to France, but early in 1938 another crisis developed and the franc fell to a little over 3 cents.

On September 27, 1936, immediately after suspension of the gold standard by France, Holland left gold, and the next day Switzerland did the same. Both these countries devalued their currencies and established stabilization funds. Together with Belgium, these countries joined the currency accord between France, Great Britain, and the United States.

The gold-bloc countries were victims of revaluations in other countries, which thereby left the currencies of the gold-bloc countries out of step with the rest of the world. Exchange rates were gradually and painfully adjusted by means of the various devaluations, to levels where trade in both directions could take place profitably. After the devaluations had been completed, exchange rates and price level relationships between the different countries were not far from where they had been prior to the currency disorders, in spite of the violent gyrations in exchange rates and the drastic declines in commodity prices that had taken place in the meantime. Figure 12 shows the declines in price levels of the leading countries from 1929-1932, and the recovery of 1933-1937. The French price level did not reach its low point until 1935, and then rose sharply, particularly after devaluation in 1936.

**The Approach of War.**—The flow of world trade increased steadily from 1933 on, as can be seen in Figure 13. As trade

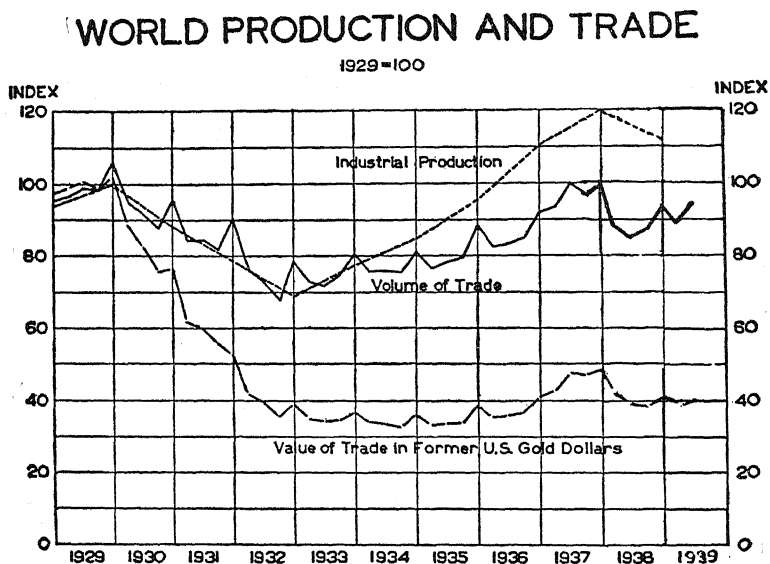


Figure 13. World Production and Trade from 1929 to 1939

(The above chart is based on League of Nations figures which are not available for the period since the beginning of the second World War.)

improved and internal commodity price levels became more stable (or less unstable), exchange fluctuations became less severe. At the beginning of 1938, trade turned downward, reflecting the economic troubles of that period. The decline, however, was short-lived and toward the end of the year trade was again expanding.

Much of this trade represented materials needed for armaments as Europe prepared for war. The accompanying table (Table 20) shows the general type of goods imported and exported by the leading countries in 1938. It will be noted that with the exception of Russia, these countries, which are all industrialized, were heavy importers of raw materials and exporters of manufactured goods.

TABLE 20. CHARACTER OF THE TRADE OF LEADING COUNTRIES  
(Based on trade during 1938)

	Foodstuffs	Raw Materials	Semi- Manufactures	Manufactured Goods
Imports				
Germany .....	40%	34%	19%	7%
Italy .....	13	48	21	18
Japan .....	7	49	27	17
United Kingdom .....	48	27%		25%
France .....	27	58		15
United States .....	30	29	20	21
Soviet Russia .....	13	39		48
Exports				
Germany .....	1	10	8	81
Italy .....	32	8	18	42
Japan .....	11	4	24	61
United Kingdom .....	9	13		78
France .....	14	32		54
United States .....	14	20	16	50
Soviet Russia .....	32	49		19

(Source: The Royal Institute of International Affairs, *Raw Materials*, London, Oxford University Press, 1939, p. 10)

When war began in 1939, world trade was still far below the 1929 level. The many restrictions on the movement of goods had prevented any real expansion of foreign trade. The trend

toward economic nationalism, mounting trade barriers, and other repressive regulations held back any broad commercial expansion. High tariffs were overshadowed by new devices such as quotas, exchange control, and bilateral clearing agreements. The international trading mechanism became increasingly clogged as a result of the governmental measures and the deteriorating political situation.

International lending during the nineteen twenties had helped to keep world trade and finance in a state of balance, but a precarious balance. Foreign lending collapsed almost completely with the depression. The numerous defaults, currency depreciations, and financial difficulties which occurred in practically every country interfered with the extension of credit, and made impossible the flotation of new loans in the world's financial centers. The investing public was in no mood to buy foreign securities, particularly in view of the threatening political situation. A result was that the maladjustments and disturbed conditions were intensified.

In April, 1937, Paul van Zeeland, then Premier of Belgium, was invited by the governments of Great Britain and France to report on "the possibility of obtaining a general reduction in the obstacles to international trade."<sup>7</sup> After visiting various countries and making extensive studies, Mr. van Zeeland presented his report in January, 1938. He recognized the serious difficulties in the way of bringing order out of the existing disorderly state of affairs. In the report he urged nations to refrain from further increases in quotas and exchange controls which, he felt, had become a greater obstruction to trade than tariffs. He expressed the hope that countries would continue to make bilateral tariff agreements to free trade from prevailing restrictions.

In regard to currency and financial problems he felt that currency stabilization at fixed gold parities would have to await great equilibrium in both the economic and financial spheres; he favored the restoration of the gold standard, but upon an altered basis. The necessity for collaboration among the various

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<sup>7</sup> *The Economist*, London, January 29, 1938.



powers in economic matters was recognized and Mr. van Zeeland urged that representatives of Great Britain, United States, France, Germany, and Italy confer as to what could be accomplished in this direction. He was aware, however, of the serious political difficulties in the way of the program proposed.

Capital came to America during these years seeking to escape the disturbed conditions and the impending war. This movement took place in spite of restrictions on the transfer of capital which existed in most countries. Great Britain held to a free market, but on the Continent of Europe and in other parts of the world where exchange control existed, black market operations were extensive. One of the methods by which capital found its way to the United States was through the invoicing of exports to this country at low values, the American importer then depositing an additional sum in the United States as directed by the exporter.

Deposit balances and other short-term assets held in the United States for foreign account increased greatly during the years immediately preceding the war, and also after the war commenced, especially after the collapse of France.<sup>8</sup> Gold poured into the United States at an unprecedented rate and built up this country's gold stock to \$16,646,000,000 in August, 1939 and to \$22,800,000,000 by October, 1941. After this date the gold stock declined slightly, partly as a result of earmarking operations. In the fall of 1942 gold held under earmark amounted to approximately two and one-half billion dollars.

**The Second World War.**—Upon the outbreak of war in the fall of 1939, emergency financial measures were adopted by most countries, neutrals as well as belligerents. In Great Britain special measures were taken prior to actual hostilities, and on August 24, 1939 there was enacted the Emergency Powers Bill. This gave the government sweeping powers over all phases of the country's economic life. In France full powers had been given the government in the spring of 1939, so that no new authority was required. The German economy was already

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<sup>8</sup> See Chapter 23.

largely on a war footing, but additional measures were taken, such as increasing taxes and preventing profiteering.

On August 25, 1939 the Exchange Equalization Fund ceased to support the pound, which depreciated rapidly as can be seen in Figure 3 on page 241. Rates for dollars had previously been maintained at approximately \$4.68. After the war began the official rates were fixed at \$4.04 buying, and \$4.02 selling, but rates in financial centers outside Great Britain continued to decline. Regulations were gradually tightened and by the fall of 1940 the effective rates for most sterling transactions everywhere were \$4.02½–\$4.03½. The Bank of England raised its discount rate from 2% to 4% on August 24, but in September lowered it to 3%, and in October back to 2%.

The British Treasury on August 24, 1939, ordered all owners of foreign securities to make a return of their holdings to the Bank of England within 30 days. This mobilization of foreign assets was to provide resources with which to purchase from abroad necessary materials. British foreign assets before the war are estimated to have amounted to about 5 billion pounds, of which 3.5 billions were long-term security investments. The total gold and dollar assets at the beginning of the war are estimated to have amounted to \$4,483,000,000.<sup>9</sup>

The Currency (Defense) Bill was passed on September 1, and provided that the resources of the Exchange Equalization Fund could be utilized for war purposes. A few days later the Chancellor of the Exchequer announced that 280,000,000 pounds in gold would be transferred from the Bank of England to the Exchange Fund, thereby increasing its available resources. The demand for dollars was great, and after the first eighteen months of war these resources were practically exhausted. Great Britain thereafter had to meet the demand for foreign exchange from overseas assets and exports. As a consequence, British foreign investments became greatly reduced.

Arrangements were made with sterling area countries to accept pounds for goods sent to Great Britain, and also to turn

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<sup>9</sup> W. Walton Butterworth, "Britain's Changing Position as a Creditor Country," *Foreign Commerce Weekly*, U. S. Department of Commerce, October 18, 1941.

over to Great Britain for pounds the foreign exchange received from their exports to non-sterling countries. Imports from the United States were paid for in dollars, but other countries received blocked balances in pounds. This is discussed in Chapter 29. Great Britain's critical need for dollars was relieved by the passage by the United States of the Lend-Lease Act in March, 1941. Most of the lend-lease aid, which by September, 1942 totaled about 6.5 billion dollars, went to Great Britain.

Commodity prices in Great Britain rose steadily after war commenced. From 98 in August, 1939, the Board of Trade index of wholesale prices rose to nearly 150 by the end of 1940. The rise from that point on was more gradual, due especially to more rigid price control measures, and in July, 1942, the index stood at 160. Price control was instituted prior to the war, but no broad price control law was adopted until November, 1939, when the Prices of Goods Act was enacted. This law was not adequate and was therefore supplemented by the Goods and Services Act of July, 1941.<sup>10</sup> The rise in prices reflected the course of inflation. The note circulation of the Bank of England expanded continually and rose from 510,000,000 pounds in July, 1939, prior to the outbreak of war, to 830,000,000 pounds in September, 1942. Provisions regarding the fiduciary circulation were revised so as to make possible this expansion.

Inflation in France proceeded much farther than in England. The circulation of the Bank of France increased from 123,000,000 francs in July, 1939, to about 160 billions when the country was overrun by Germany, and to about 351 billions in September, 1942. The circulation of the Reichsbank rose from 8,989,000,000 marks in July, 1939, to over 20 billion marks in May, 1942. Due to the official controls, wholesale prices in Germany showed very little increase. Under the rigid German system, price indices have little significance as a guide to the purchasing power of money. Similarly, in any country, the greater the degree of price control the less meaningful are price indices.

<sup>10</sup> Thomas R. Wilson, "British Price Control Legislation," *Foreign Commerce Weekly*, U. S. Department of Commerce, September 27, 1941.

When Germany invaded Denmark and Norway in April, 1940, the United States froze the assets owned by these countries in the United States. The purpose was to prevent the American funds and property of these countries from being used by Germany, and to protect such assets for their owners. Freezing was extended to other countries as they were conquered by Germany. In June, 1941, the United States finally froze German and Italian assets, the reason in this instance being to prevent their use for purposes inimical to the United States. In anticipation of such freezing, large sums were transferred by these countries to Latin America, especially to Argentina. Japanese assets were frozen July 25, 1941, after which date all transactions with Japan were subjected to licensing. Inasmuch as no licenses were granted, trade with Japan came practically to a halt.

In June, 1941, the United States banned all trade and financial dealings with nationals of states whose assets were blocked, and with firms in which such nationals had a substantial interest. The ban threatened to halt all foreign trade of the United States, especially in Latin America where Axis nationals had extensive interests. This was because American traders could not be sure whether Axis nationals were interested or not in the foreign companies with which Americans were carrying on transactions. Violation of the prohibition carried a fine of \$10,000 and 10 years in prison. Accordingly in July, 1941, the President issued the "Proclaimed List of Certain Blocked Nationals," which became known as the black list, and which contained about 1,800 names. A general license was issued permitting trade with persons or firms not on this list. Firms suspected of being cloaks for Axis transactions were also included in the ban. Japanese firms were not added to the list until after the attack on Pearl Harbor, December 7, 1941. The list was expanded from time to time, and also some names were removed after Axis interests were eliminated or undesirable practices discontinued.

Export control was instituted by the United States in July, 1940, and by April, 1941, nearly half of the exports of this country were subject to licensing. Licenses were first required

for arms, ammunition, certain machine tools, chemicals, and raw materials. After the United States entered the war all exports were placed under license.

As a result of the war, governments everywhere greatly increased their supervision over the affairs and economic life of their peoples. While such control will be modified as time goes on, it means permanent and significant changes in the relation of governments to economic activity.

## CHAPTER 38

### THE BRITISH ECONOMY

**The British Empire.**—The British Empire, or British Commonwealth of Nations, as at present constituted, includes about one-fourth of the population of the entire world, or in other words about 500,000,000 people of every color, race, and creed. It covers about a fourth of the habitable area of the globe, about half of the Empire being in the northern hemisphere, and half in the southern hemisphere.

Member territories of the Empire live under varying degrees of political independence. At one extreme are the self-governing Dominions, whose bond to the Empire is largely a matter of loyalty and economic interest. The Dominions, which are all equal in status, include Australia, Canada, the Irish Free State, New Zealand, and the Union of South Africa. At the other extreme are the mandated territories, which are administered directly from London by authority from the League of Nations. These consist of former German and Turkish possessions taken over by the Allied powers after the first World War, and include such areas as Samoa, New Guinea, and Palestine. Like the mandated territories, in that they are under a large degree of control from the mother country, are the so-called protectorates, such as the Federated Malay States, and the Crown Colonies, such as Hong Kong and the Straits Settlements. India, which has long sought Dominion status, stands in a class by itself. The Empire includes seven members of the League of Nations: Great Britain, Australia, Canada, India, New Zealand, the Union of South Africa, and the Irish Free State.

The extensive Empire of Great Britain has had a great influence upon British economic life and policy, domestic as well as foreign. The high degree of industrialization of Great Britain

has been due in no small measure to the extensive overseas possessions. Trade within the Empire is on a preferential basis of varying degrees, as already discussed. Most of the goods received by Great Britain are in the nature of raw materials and food, while member countries receive in return British manufactured articles and finished products. The large British navy and merchant fleet are vital to Great Britain in the maintenance of communications between the mother country and the widely separated parts of the Empire. The Empire has gradually tended to become more loosely knit as the different elements leaned toward greater independence. The war has accelerated this tendency, particularly since the Empire learned that it could not rely on Great Britain for military protection.

**British Commercial Supremacy.**—Great Britain, or the United Kingdom<sup>1</sup> prior to the war ranked first in international trade and finance according to several bases of measurement. In the first place, Britain's total foreign trade exceeded that of any other country.<sup>2</sup> Furthermore, British foreign investments were the largest of any nation. The British merchant marine occupied a position of unquestioned supremacy and touched practically all ports of the world, large and small. London was an outstanding international money market and world *entrepôt*. Great Britain held this preeminent position in world commerce, although the country occupies an area only a little over two-thirds that of California.<sup>3</sup> On this small area live approximately 45,000,000 people.

The war has greatly affected Great Britain's position. Her trade has been cut off, which, however, is largely temporary. The great reduction in her foreign investments is more serious. Much of her merchant marine has been sunk, and at the rate

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<sup>1</sup> The expression United Kingdom refers to England, Wales, Scotland, and Ireland (now North Ireland only), the Isle of Man, and the Channel Islands. Together these constitute the British Isles.

<sup>2</sup> In the peak year, 1929, the foreign commerce of the United Kingdom, including imports and exports, amounted to a little over 10 billion dollars (about £2,000,000,000). In 1940 it amounted to a little over 6 billion dollars (about £1,500,000,000 at the rate of \$4 per pound). Of this sum approximately \$4,400,000,000 were imports. In 1938 total trade amounted to about \$6,500,000,000 of which about \$4,200,000,000 were imports.

<sup>3</sup> The area of the British Isles (England, Scotland, Wales, and all of Ireland) is 110,874 square miles; including only Northern Ireland the area is 94,278.

the United States is building ships, this country's merchant marine fleet will soon surpass that of Great Britain.

Great Britain has owed her commercial supremacy to a number of fortunate circumstances. Not the least is the country's geographical position. Isolated from the Continent by a narrow strip of ocean, Britain was free from many of the quarrels and military struggles of Europe, and was able to concentrate energies on commercial and industrial activities. The westward location made Great Britain the most favorably situated European country for trading with the new world. England, moreover, early adopted and consistently pursued the policy of encouraging artisans from the countries across the channel to settle within its borders. Thus the most advanced technical knowledge in many fields centered in England. It was in Great Britain that the important mechanical inventions in spinning and weaving took form, which signalized the beginning of the Industrial Revolution. Furthermore, England possessed huge reserves of coal and substantial stores of iron ore, so that the country was naturally suited to industry. These mineral resources were a most important factor in the industrialization of the country. Great Britain early developed financial institutions of world importance, and accumulated large supplies of capital for investment at home and abroad. Great Britain was thus the first country to develop industrially and, as a result of the early start, was able to dominate world industry and commerce.

**Natural Resources.**—An industrialized country as important in world commerce as Great Britain might be expected to have an abundance of the basic raw materials of industry. Such is not the case. The only important industrial raw material which Great Britain possesses in large quantities is coal. Britain is the second largest producer of coal, the United States being first. The known reserves of coal in Great Britain are extensive—sufficient to last for seven or eight centuries at the present rate of consumption.<sup>4</sup> Formerly, Britain produced enough iron ore to meet its needs, but for over 40 years has been mining less

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<sup>4</sup> R. H. Whitbeck and V. C. Finch, *Economic Geography*, 3rd ed., New York, McGraw-Hill Book Co., Inc., 1935, p. 345.



and less ore and importing more and more, so that about 60% of the ore which Great Britain now uses normally comes from other countries.<sup>5</sup> While coal accounts for over 90% of the average value of British mineral products, iron ore accounts for only about 3%.<sup>6</sup>

Small amounts of tin, lead, bauxite, and tungsten are produced in the British Isles, but not nearly enough to supply domestic needs. British tin mines have been worked since the twelfth century, but at present very little tin is secured from them. Sulphur and phosphates are the only other important minerals which are produced in significant amounts in Great Britain. All the nickel, manganese, mercury, zinc, antimony, chromite, mica, and cotton which Britain uses must be imported.

**Merchandise Imports.**—The circumstances which enabled Great Britain to achieve commercial and industrial preeminence in spite of relatively few natural resources have already been considered. Britain, however, has attained this position at the cost of great dependence on other nations. Of all the major industrial nations Great Britain is the least self-sufficient. Particularly is Britain dependent on other countries for food. Less than 7% of the people living in the United Kingdom are engaged in agriculture, and only about one-fourth of the land is cultivated.<sup>7</sup> Half or more of the food consumed in Great Britain is in ordinary times obtained from other countries. Wheat is imported from Canada, the United States, Argentina, and Australia. Beef is obtained from Argentina, Australia, New Zealand, and Uruguay; mutton from Australia, New Zealand, and Argentina; bacon from Denmark, Holland, the Irish Free State, and the United States; and ham and lard chiefly from the United States. Dairy products are secured mainly from Denmark and New Zealand.<sup>8</sup> Britain produces domestically about 60% of its own meat and a large portion of its fruits and vegetables.

<sup>5</sup> *Ibid.*, p. 347.

<sup>6</sup> *Ibid.*, p. 348.

<sup>7</sup> Whitbeck and Finch, *op. cit.*, p. 343.

<sup>8</sup> Isaac Lippincott, *The Development of Modern World Trade*, New York, D. Appleton-Century Co., 1936.

The principal imports into Great Britain, in order of importance according to value, were, prior to the war, meat, grain, and flour, raw cotton, raw wool, wood and timber, oils, fats, resins, and manufactures.<sup>9</sup> It is significant that the first two groups are foods. Of the countries from which Britain buys, the United States ranks far ahead of all others on the basis of value. The United States exports approximately twice as much to Great Britain as its nearest rival. In addition to the United States, the principal sources of British imports are normally Argentina, Denmark, Germany, Australia, France, British India, and Canada.

**Merchandise Exports.**—The textile industry is Britain's largest industry, and produces the country's chief export. The British cotton industry is much larger than the woollen industry, although all the raw cotton used must be imported. About a fourth of the raw wool used by British factories is produced in Great Britain. Linen manufacture is confined chiefly to Ireland, and has its center in Belfast.

The British textile industry, as already mentioned, suffered greatly from foreign competition in the years following the first World War. Exports of cotton goods dropped considerably over one-third between 1913 and 1928;<sup>10</sup> this decline was very depressing to British industry. The woollen industry was less adversely affected than that of cotton. Asia, which had been the most profitable market for British cotton goods, has been, since the first World War, producing its own textiles and has become Britain's chief competitor. At first the competition was most keenly felt from mills in India and China, but in recent years it came chiefly from Japan. The second World War has stimulated the textile industry in Latin America, although the difficulty of obtaining machinery has slowed down this development.

Next to textiles, coal is Great Britain's chief export. Of Europe's known reserves of coal, Britain has over half.<sup>11</sup> British coal is of good quality, some of it being better than any

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<sup>9</sup> *Statesman's Yearbook*, 1937.

<sup>10</sup> Lippincott, *op. cit.*, p. 134.

<sup>11</sup> Whitbeck and Finch, *op. cit.*, p. 345.

of the bituminous coal found in the United States. British coal is shipped to France, the Scandinavian countries, Italy, Germany, South America, and elsewhere.

Britain has had severe troubles with its coal industry. Demand for British coal has fallen off as a result of the substitution of petroleum, the growth of hydroelectric power, and the development of lower-cost coal mines abroad. Labor problems and unemployment in the British coal industry have thus been particularly acute, and prior to the war were the source of special concern to the government.

The other leading exports of Great Britain are iron and steel manufactures, machinery, and chemicals. English manufactures are in wide favor for their high quality and dependability, and are generally of a standard, staple type rather than of a luxury character. Along with iron and steel, shipbuilding occupies a prominent place. Britain ordinarily builds about as many ships as all other countries combined, but the great expansion of shipbuilding facilities in the United States to meet war needs has altered this situation. The chemical industry is growing in importance, but still ranks considerably below the industries mentioned. Britain's chief customers, in approximate order of importance, are normally British India, the Irish Free State, the United States, France, Canada, Germany, and Argentina.

Great Britain has a large *entrepôt* trade, receiving goods from all over the world and re-exporting them to other countries. A great many commodities of all types thus pass through Great Britain. This is partly because of the British dominant position in shipping, and the facilities which Great Britain provides. Britain, therefore, exports, or redistributes, large quantities of articles which she does not produce, such as rubber, tin, furs, and skins. Most of Britain's re-exports come from areas within the British Empire, particularly from British possessions in the Far East and in South Africa.

Table 21 shows the imports and exports of Great Britain since 1913.

**Balance of Payments.**—For many years, Great Britain has regularly had an excess of merchandise imports, a so-called un-

favorable balance of trade. Prior to the war, exports amounted, on the average, to only about 60% of imports, according to value.<sup>12</sup>

TABLE 21. FOREIGN TRADE OF GREAT BRITAIN

Year	IMPORTS	EXPORTS		
		Goods Produced in Great Britain	Re-exports	Total Exports
1913.....	£ 768,734,739	£ 525,253,595	£ 109,566,731	£ 634,820,326
1914.....	696,635,113	430,721,357	95,474,166	526,195,523
1915.....	851,893,350	384,868,448	99,062,181	483,930,629
1916.....	948,506,492	506,279,707	97,566,178	603,845,885
1917.....	1,064,164,678	527,079,746	69,677,461	596,757,207
1918.....	1,316,150,903	501,418,997	30,945,081	532,364,078
1919.....	1,626,156,212	798,638,362	164,746,315	963,384,677
1920.....	1,932,648,881	1,334,469,269	222,753,331	1,557,222,600
1921.....	1,085,500,061	703,399,542	106,919,306	810,318,848
1922.....	1,003,098,899	719,507,410	103,694,670	823,202,080
1923.....	1,096,226,214	767,257,771	118,543,805	885,801,576
1924.....	1,277,439,144	800,966,837	139,970,143	940,936,980
1925.....	1,322,858,167	773,086,410	154,410,967	927,497,377
1926.....	1,242,863,679	651,892,504	125,565,633	777,458,137
1927.....	1,218,341,150	709,081,263	122,952,829	832,034,102
1928.....	1,196,940,354	723,427,455	120,352,491	843,779,946
1929.....	1,220,765,300	729,349,322	109,701,828	839,051,150
1930.....	1,043,975,261	570,755,416	86,835,409	657,590,825
1931.....	861,252,638	390,621,598	63,867,549	454,489,147
1932.....	701,670,061	365,024,008	51,021,256	416,045,264
1933.....	675,016,119	367,909,052	49,080,727	416,989,779
1934.....	731,400,000	396,000,000	51,200,000	447,200,000
1935.....	756,000,000	425,800,000	55,300,000	481,100,000
1936.....	847,800,000	440,600,000	60,800,000	501,400,000
1937.....	1,027,812,000	521,400,000	75,100,000	596,500,000
1938.....	919,509,000	470,755,000	61,525,000	532,280,000
1939.....	885,513,000	439,536,000	46,033,000	485,569,000
1940.....	1,099,869,000	413,084,000	26,189,000	439,273,000

(Source: League of Nations' *Monthly Bulletin of Statistics*, *World Almanac*, *Westminster Bank Review* and *Statesman's Yearbook*)

The merchandise trade, however, is only a part of the picture. Great Britain has a large invisible trade consisting of

<sup>12</sup> *Monthly Bulletin of Statistics*, League of Nations.

so-called service items, which makes up the difference between exports and imports. Great Britain annually sells to other nations a large amount of services for which she must be paid. Among the services which Great Britain renders to foreigners, or "exports to them," are the services of British ships in carrying goods and passengers. Other services include insurance written for foreigners, and work performed by British commercial houses, banking houses, and brokerage houses, for which a commission is charged. Another important item consists of services rendered to travelers in Great Britain. These various services performed by Great Britain are to be considered the same as exports, and must be paid for by foreign countries through shipments of goods to Great Britain or in other ways.

In addition to the above services, which help to pay for the excess of merchandise imports into Great Britain, are interest and dividends paid to Great Britain by foreigners because of British funds invested abroad. Great Britain has long been a creditor nation, although, as noted below, the war has greatly weakened her position. British preeminence, first commercially and later industrially, gave rise to "surpluses" of capital which sought the more attractive returns characteristic of undeveloped regions.

As a consequence Great Britain has been able to receive goods from all over the world, raw materials, foodstuffs, fuel, and manufacturers, without needing to pay for all these by current exports since the toll she collects upon her foreign investments provides for much of the payment. Before the war approximately one-fourth of Britain's imports were delivered as a return upon capital which had been loaned abroad. This income amounted to about one-twentieth of the country's total national income.<sup>13</sup>

As a result of the war British foreign investments have been greatly depleted. In 1939, British capital abroad in all forms is estimated to have amounted to about £5,000,000,000; of this sum £3,500,000,000 consisted of long-term investments. After war began, Great Britain needed large amounts of for-

<sup>13</sup> "British Capital Abroad," *The Economist*, London, November 20, 1937, pp. 359-366.

eign currency, especially dollars, with which to purchase necessary war materials; the supply of exchange currently being created from exports, dividends, interest, and other items was inadequate. During the first year of the war Great Britain therefore drew upon her foreign resources to the extent of approximately £542,000,000, of which £184,000,000 came out of the Exchange Equalization Fund. The difference came from gold exports, balances held in American banks, the sale of securities abroad, many of which were requisitioned from the British public, and from the increase of foreign balances in London.

During the second year of the war the remaining resources of the Exchange Fund were practically exhausted, this in the first six months, so that Great Britain had to look almost entirely to overseas assets in meeting the deficit in the balance of payments. Shortly before the United States entered the war, the total decline in British foreign capital is estimated to have amounted to at least £1,250,000,000.<sup>14</sup> As regards gold and dollar resources, it has been estimated that at the time the United States entered the war less than one-fifth of such pre-war assets remained unpledged or still owned by Great Britain. At the beginning of the war gold and dollar assets had amounted to about \$4,483,000,000. Furthermore, payments were still being made in the United States upon contracts entered into prior to the Lend-Lease Act. The liquidation of securities had proceeded on a large scale, and one direct investment was sold outright for \$54,000,000. The Reconstruction Finance Corporation had made two loans aggregating \$465,000,000 collateralized by over \$500,000,000 of investments. The adoption of the Lend-Lease Act in March, 1941, relieved the pressure for foreign exchange.

Prior to the war the income on Britain's foreign investments amounted to some £200,000,000 annually. The loss of the major portion of this income may have serious repercussions on the country's economy, particularly since Great Britain requires large imports to live. It means that Great Britain will need to expand exports in order to pay for the imports which are essential to her highly industrialized economy.

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<sup>14</sup> W. Walton Butterworth, "Britain's Changing Position As a Creditor Country," *Foreign Commerce Weekly*, October 18, 1941.

Income from shipping services rendered to foreigners has long been an important source of foreign exchange to Great Britain, helping to pay for imports. This income ranked next to that from foreign investments, and before the war amounted to some £100,000,000 each year. British ships carried about two-thirds of Britain's ocean trade and about 45% of the entire world's ocean trade. The effect of the war upon British shipping is discussed in Chapter 5.

**Commercial Troubles.**—During the inter-war years British industry and trade were in a state of almost continuous depression. The export trade suffered particularly, as noted above. With the world-wide depression which began late in 1929, the situation became critical. By 1933 both exports and imports had declined to about half what they had been in 1929. Because of Great Britain's specialized economy and dependence upon foreign materials, foreign markets are especially important. In order to import, Great Britain must also export; hence, the great slump in her trade, much of which seemed chronic, was a matter of no small consequence.

The change in Great Britain's trade was due in large measure to forces generated by the first World War; but part of the difficulty can also be traced to tendencies evident long before 1914. England was the first country to develop industrially, and until well past the middle of the nineteenth century was without serious competition in manufacturing. The absence of competition enabled her to make good profits from exports of manufactures, and until about 1880 British prosperity increased at a rapid rate.

The development of foreign competition was inevitable, and was hastened by British investments in industries abroad. By 1880 Great Britain found that both Germany and the United States were challenging her industrial supremacy, and were beginning to force down prices. Other countries also offered competition.

Until the first World War, Great Britain did not suffer greatly from these new developments. The war, however, seriously interrupted British trade and industry, and the scarcity of

shipping made British and other European goods unavailable to many countries that ordinarily bought heavily. The war gave Japan, the United States, and other nations the opportunity to dominate markets which previously had been largely British. Thus United States trade with South America increased rapidly during the war, largely at Great Britain's expense.<sup>15</sup> The Orient, shut off from British textiles during the war, developed its own textile mills, with the result that British textile mills found much of their former market permanently gone.

During the war and the years immediately following, technological changes were made in industry in America and in other parts of the world. On the continent, factories had been destroyed and were now replaced with modern equipment. In the Orient new factories and mills had been built under the stimulus of high wartime prices. Thus Britain found herself at the end of the war with hundreds of industrial plants which were obsolete, plants in which production costs were substantially higher than in several other countries. Throughout the twenties, British industrial production costs were high as compared (via exchange rates) to those in other countries. The effect of this was to discourage British exports. The foreign market for British coal, moreover, was interfered with by petroleum and hydroelectric developments, with resultant depression and chronic unemployment in the coal industry. To a nation dependent on other countries' materials, as was Great Britain, the trend of events was not healthy.

Added to these troubles, the immediate effect of the return to the gold standard in 1925 at the former par was to make British goods more expensive in terms of foreign currencies, and hence to restrict exports. This high gold value of the pound required a reduction of prices and costs within Great Britain, i.e., deflation, which increased the depressed conditions.

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<sup>15</sup> From 1913 to 1929, the imports of Argentina increased from \$492,000,000 to \$856,000,000; the proportion of these imports from the United States increased from 15% to 25%. Brazilian imports during the same period increased from \$324,000,000 to \$416,000,000, the proportion from the United States increasing from 16% to 30%. Imports of Chile rose from \$120,000,000 to \$193,000,000 and the proportion from the United States from 17% to 34%. During the same period, the proportion of imports into these countries from Great Britain decreased. C. E. Griffin, *Principles of Foreign Trade*, Rev. Ed., New York, The Macmillan Co., 1934, p. 166.



Great Britain was compelled to undergo extensive and painful industrial readjustment. During the years prior to the second World War she accomplished considerable in modernizing her equipment and adapting industries to the changed conditions. The abandonment of gold in September, 1931, and the depreciation of sterling relieved the prolonged depression. Great Britain was better able to compete in the world's markets. Her economic problems, however, were far from solved, and a large portion of her foreign markets were not regained. British economic life is based largely on the extremely competitive textile, coal, and iron and steel industries, and these were not very prosperous.<sup>16</sup>

The trend in many countries toward autarky, together with the rapidly deteriorating international economic and political situation, was especially harmful to a nation whose economy is as intimately linked to international trade as that of Great Britain. The rearmament program provided a stimulus, and a certain type of prosperity. Then came the second World War, the great speeding up of British industry, and its adjustment to mechanized warfare. The second World War has presented commercial problems for the post-war period that are different, but no less difficult than those following the former war. One thing is clear, namely, that Great Britain must do all in her power to expand the export trade.

**Commercial Policy.**—Prior to the Industrial Revolution British trade policy was strongly mercantilistic, and based upon the philosophy that exports should be stimulated but imports held to a minimum. Imports into Great Britain were thus restricted by heavy duties, while exports were encouraged by various means. Strict navigation laws limited commerce with British colonies to British vessels, and colonial economic life was subordinated to the supposed interests of the mother country.

Because of the far-reaching economic changes which accompanied the Industrial Revolution, England reversed its commer-

<sup>16</sup> For a more extended discussion of Great Britain's inter-war commercial problems, see André Siegfried, *England's Crisis*, New York, Harcourt, Brace & Co., 1931; Ernest Minor Patterson, *The World's Economic Dilemma*, New York, McGraw-Hill Book Co., Inc., 1930, Ch. X; and G. D. H. Cole, *British Trade and Industry*, London, Macmillan & Co., Ltd., 1932.

cial policy during the first half of the nineteenth century. The Industrial Revolution, as already noted, emerged first in Great Britain, and, so long as Great Britain remained the only industrialized country, a protective policy was of no benefit to British industry since there were practically no rivals attempting to supply the home market. A protective policy, on the contrary, was harmful to industry, since it made food and raw materials more expensive. Influenced by the laissez-faire philosophy of Adam Smith and by the altered economic situation, British leaders secured the removal of the various mercantilistic restrictions on trade. In 1846, after a long campaign led by Richard Cobden and John Bright, the Corn Laws (duties on wheat) were repealed. From about 1860 to the first World War, England pursued a policy of practically complete freedom of trade.

The first World War caused the pendulum to swing in the other direction, although agitation for protection had been evident long before 1914. The steps by which Great Britain returned to a protective policy are discussed in Chapter 28.

The change in policy was again a reflection of changed economic conditions, changes which antedated the war. So long as Great Britain had little industrial competition in the home market from other countries, free trade was well-nigh unanimously recognized by industrialists as well as by economists, as the logical policy. Before the end of the nineteenth century, however, stiff competition from abroad had developed, competition which continuously grew keener. The result was anxiety among those industries that were affected, concerning retention of their markets. Protection was proposed as a remedy.

The depreciation in continental currencies after the first World War caused foreign goods to be cheap in Great Britain, as already discussed. This situation, together with the disrupted trade generally throughout the world, and the example of extremely high tariffs and various restrictive devices of other countries, sufficed to turn Great Britain toward protection. It was also realized that a tariff would place the country in a better bargaining position with other countries. In a sense Great Britain adopted protective tariffs as a measure of self-defense.

The wisdom of departing from the historic course and adopting a protectionist policy was widely debated. The fact that no

major nation was more dependent upon other countries for its economic well-being than Great Britain, was held to constitute a strong reason for not interfering with trade, but giving it full freedom. On the other hand, it was argued that a carefully planned protective policy could make Britain less dependent on foreign countries and more economically secure in a world continually unsettled and threatened with war.<sup>17</sup> The outbreak of war halted the argument and raised new questions regarding the post-war commercial pattern.

**Currency System.**—Prior to 1914 Great Britain was completely upon the gold standard, having both free and gratuitous coinage of gold and unrestricted exportation and importation of gold. Great Britain had been upon the gold standard continuously since 1821, when specie payments were resumed after a period of about 24 years of inconvertible paper money. This period of inconvertible paper money was due to the Napoleonic wars. The Bank of England had been called upon to finance the government to a large extent, and in February, 1797, was forced to suspend specie payments. Parliament in May of the same year passed the so-called Restriction Act, indemnifying the Bank, providing for inconvertibility of notes, and making the notes legal tender.

The currency system before 1914 was based upon the gold sovereign or pound, which contained 113.0015 grains of pure gold, and which was thus worth about \$4.8665 in American money (before devaluation of the dollar). The pound is divided into twenty shillings, the shilling into twelve pence, and the penny into four farthings. Standard gold coins were unlimited legal tender in Great Britain, but the silver coins were fiduciary and were legal tender only to the extent of £2. The paper currency consisted of notes of the Bank of England and of the joint-stock banks. The notes of the joint-stock banks were not legal tender, and their circulation was confined largely to the locality of the bank issuing them, while notes of the Bank of

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<sup>17</sup> John Maynard Keynes, in a much debated article ("National Self-Sufficiency," *Yale Review*, May, 1933) advocated a policy of greater economic independence for Great Britain. He believed the gains received from such a policy would more than compensate for the theoretical sacrifice in the general standard of living.

England were legal tender and enjoyed national currency. Some of the banks in Scotland and Ireland also issued notes, but, like the notes of the joint-stock banks, these were not legal tender and had only local currency. Thus the chief paper currency before the first World War consisted of the notes of the Bank of England.

The gold standard ceased to exist in Great Britain in August, 1914, although nominally it continued until May, 1917, when the exportation of gold was prohibited by proclamation. Although the paper currency was nominally redeemable in gold at all times, in practice redemption was frowned upon and, in fact, actually refused. During the war, anyone endeavoring to secure gold was put in the position of being very unpatriotic. Inconvertibility remained on this *de facto* basis until England returned to gold in the spring of 1925.

During the war, paper currency was issued by the British Treasury under the Currency and Bank Notes Act of August, 1914. The notes of the Bank of England were in denominations not smaller than £5 (nearly \$25), but this act permitted the Treasury to issue so-called currency notes in denominations of £1 and 10s. These notes had behind them a small amount of gold, but rested principally upon government securities. They continued in circulation after the war, and in 1928 were assumed by the Bank of England. The fiduciary issue of the Bank was accordingly increased.

On April 28, 1925, Great Britain returned to gold by granting to the Bank of England a general license to export gold. On May 13, 1925, the so-called Gold Standard Act was adopted (effective December 31, 1925), which established the gold bullion standard by relieving the Bank of the obligation of redeeming its notes in gold coin, and also of coining bullion. The Bank became obligated to buy or sell gold only in quantities of 400 ounces or more, the buying price to be a minimum of £3 17s 9d per standard ounce, the same as previously.<sup>18</sup>

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<sup>18</sup> The standard ounce in Great Britain refers to gold  $11\frac{1}{2}$  fine. The mint price was £3 17s  $10\frac{1}{2}$ d per standard ounce of gold. Since the Bank in taking gold to the mint for coining had to wait for the coining to be completed before receiving gold sovereigns, the difference between the buying price and the mint price allowed the Bank interest, or a slight profit if the Bank did not have the gold coined.

Because of the international run on the Bank of England which developed in 1931, England once more abandoned gold in September of that year. A common procedure among countries going off the gold standard has been to proclaim an embargo on gold exports, but England did not do this. Instead, the provision in the Gold Standard Act of 1925 which directed the Bank to sell gold in 400-ounce bars, i.e., redeem notes in gold, was suspended. Although redemption in specie was suspended, the free gold market in London was retained. Gold, of course, went to a premium in terms of British paper. The world's gold market, like that of silver, centers in London, and gold from the mines in South Africa and elsewhere is transported to London where it is bought and sold.

The second World War caused very little change in the British currency system, apart from a considerable expansion in the circulation of the Bank of England and removal of the gold behind this circulation, discussed below. Great Britain was already off the gold standard so that currency affairs continued very much as they had been. The pound depreciated in the foreign-exchange market, but was soon pegged at about \$4.02½–\$4.03½, as already noted. The Exchange Equalization Fund became almost entirely depleted, as its resources were used to pay for essential imports.

The course of exchange rates between the pound and the dollar, and of the purchasing power parities between the two currencies, is shown in Figure 3 on page 241. In Figure 12 on page 638 are shown the movements of the British commodity price level.

**The Bank of England.**—The central institution in British finance is the Bank of England, the oldest central bank in the world. In 1691, William Paterson prepared a project for a bank that would be similar to the strong banks on the continent that by that time had already become well established. These included the Bank of Amsterdam, founded about 1608 or 1609 (liquidated in 1790), the Bank of Venice, founded in 1619 (discontinued in 1806), and the Bank of Genoa which traced its early beginnings to 1148 in the form of a company created

to make a loan to the republic. The exact date when the Bank of Genoa began to do a banking business is not entirely clear. The Bank failed in 1797 and passed out of existence.<sup>19</sup>

At the time of Paterson's proposal the English Government of William III was in need of funds to prosecute the war against France. Finally, in 1694 Parliament passed a law known as the Tonnage Act which provided for the Bank. It was to be a joint-stock company known as "The Governor and Company of the Bank of England," still the official title of the Bank. The Bank was to make a loan of £1,200,000, its entire capital, to the government at the rate of 8%.<sup>20</sup> The Bank was allowed to receive deposits, issue notes payable upon demand, and make loans. It was entirely a private institution, although close to the government from the very beginning. In 1709, the Bank was given a monopoly of note issue in England, but in 1826 joint-stock banks were allowed to issue notes at a distance of 65 miles from London.

The Bank had a wholesome effect upon business. It helped to stabilize exchange rates, assisted in the marketing of the government's annuities, and loaned money to the community upon reasonable rates of interest. The Bank successfully weathered the financial crises of 1763, 1772, and 1783, but in 1797 was forced to suspend specie payments for an extended period.

England was drawn into war against France in 1793. The Bank at that time was in a strong condition, but as William Pitt, Chancellor of the Exchequer, made demands upon it and as it made large loans to the government and accordingly increased its note issue the Bank's cash reserve began to be depleted. In 1797, a run on the country banks took place because of fears of a French invasion. The country banks thereupon drew down their balances with the Bank of England, so that its specie reserves declined rapidly. The Bank Restriction Act was therefore passed that year, prohibiting the Bank from paying out specie, with a few exceptions, and making its notes receiv-

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<sup>19</sup> Harvey E. Fisk, *English Public Finance*, Bankers' Trust Company, New York, 1920.

<sup>20</sup> As the charter was renewed from time to time the loan to the government was expanded and at present amounts to £11,015,100. In 1844, the charter was extended for an indefinite period, terminable upon one year's notice and repayment of the debt by the government.

able for taxes. Bankers and merchants assembled and passed a resolution agreeing to accept the notes freely.

Not until 1819 was the Restriction Act repealed, when provision was made for resumption of specie payments by the Bank in 1821. From then until 1914 the notes continued redeemable in gold, although the Bank passed through several difficult periods.

The present form of the Bank of England dates from the Peel Act of 1844. This Act divided the Bank into two departments, the Banking Department and the Issue Department. The division is principally a matter of bookkeeping. The duties of the Issue Department are of a routine nature and consist of issuing notes and holding the security behind them. If the Banking Department wants more notes it receives them from the Issue Department by turning over gold or proper assets. Under the Peel Act the Bank is required to hold against all notes it issues, coin or bullion,<sup>21</sup> to the extent of 100%, with the exception of a fixed fiduciary issue against which government securities are to be held. The fiduciary issue was limited by the Peel Act to £14,000,000, which was the debt of the government to the Bank at the time of the Act, £11,000,000 of this amount being the perpetual debt to the Bank. Whenever any of the joint-stock banks gave up their right to issue notes, the Bank of England could increase its fiduciary issue to the extent of two-thirds of the lapsed issue. In this way the uncovered issue gradually increased, the last private bank giving up its issue in 1923.

In August, 1914, the Currency and Bank Notes Act was passed which, in addition to providing for the issue of notes of £1 and 10s by the Treasury, gave the Treasury authority to suspend the Bank Act, thereby permitting expansion of the fiduciary issue beyond the fixed amount. Such expansion was not allowed to take place, however, except temporarily (it does not show in any bank statement since the situation was remedied before a statement was issued), and the bank notes continued to be backed fully by gold except for the limited fiduciary issue.

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<sup>21</sup> One-fourth of the metal may be silver, but the Bank ceased holding silver as security for notes in 1853.

During the second World War, the Bank's gold was transferred to the Exchange Equalization Fund and the fiduciary issue accordingly expanded.

Great Britain returned to the gold standard in 1925, but specie payments were resumed by the Bank only in amounts of not less than 400 ounces of gold, as discussed above. The next change in the Bank came in 1928 when the Currency and Bank Notes Act of 1928 provided for the taking over by the Bank of the currency notes of £1 and 10s issued by the Treasury, together with the assets behind them. The fiduciary issue was thereupon greatly increased and fixed at £260,000,000, with the provision that the issue could be raised or lowered with the consent of the Treasury for a period of six months, the period being renewable during two years.<sup>22</sup>

The possible increase of the fiduciary issue when conditions make this desirable provided needed flexibility in the currency. The former system was too inelastic and unadapted to changing economic conditions. The present system is still somewhat rigid in comparison to that of America, Canada, and other countries, but is an improvement over the former arrangement under which the Bank in emergencies had been compelled to break the law.

In January, 1939 the Bank of England transferred £200,000,000 of its £327,000,000 of gold to the Exchange Equalization Fund, which paid for it with government securities. The fiduciary circulation was thus increased from about £230,000,000 to about £400,000,000. At the same time the Chancellor of the Exchequer submitted a bill to Parliament which provided for the revaluation of the Bank's gold holdings. The United States, France, and other countries had previously devalued their currency in terms of gold, and had accordingly written up the value of their gold. This measure, which received the Royal Assent on February 28, 1939, and was known as the Currency and Bank Notes Act, provided that the Bank's gold was hence-

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<sup>22</sup> In order to cope with the banking crisis in the summer of 1931, the fiduciary issue was expanded to £275,000,000 on August 1 of that year. When the Treasury authority for this increase finally expired on March 31, 1933, the Bank did not again ask its renewal, the fiduciary issue being reduced to the regular figure of £260,000,000.



forth to be valued weekly at the market price, which was then approximately 148 shillings per fine ounce, instead of the statutory price of 84 shillings 10½ pence. If the Bank's gold were in the future to increase in value, the Bank was to pay the profit into the Exchange Equalization Fund, while if the value were to decline, the Fund would reimburse the Bank.

After the adoption of the bill the Bank's remaining gold was written up by about £100,000,000 so that the fiduciary circulation in March, 1939 was correspondingly reduced by about this amount, the net result of the entire operation being an increase of the uncovered issue from about £230,000,000 to about £300,000,000.

After war broke out, the government announced in September, 1939 that it was transferring about £280,000,000 in gold from the Bank to the Exchange Fund. This entailed an increase in the fiduciary note issue from approximately £300,000,000 to £580,000,000, and left the British currency almost entirely unbacked by gold. As the war progressed the circulation of the Bank expanded, and in September, 1942 totaled £830,000,000.

Although the Bank of England is very close to the government, the Bank is entirely privately owned and managed. It is governed by a court of 24 directors, a governor, a deputy governor, a comptroller, and a chief cashier. The board, or court, is elected by the stockholders, each stockholder having only one vote, and being required to have at least £500 of stock to be eligible to vote. The offices of governor and deputy governor have usually been passed around every two years, the deputy governor succeeding the governor, and the oldest director who has not yet served being elected deputy governor. In emergency periods this practice has not always been followed, and the present governor, Montagu Norman, has served since 1920. It is an unwritten law that no director shall also be a director of one of the large joint-stock banks.

The Bank of England keeps the gold reserves of the nation. The joint-stock and private banks of London deposit their cash with the Bank of England, except such cash as they need for over-the-counter payments. All British banks, including the banks of Scotland and Ireland, keep some of their money with

the Bank of England, and usually some with the London joint-stock banks, particularly with the so-called "big five."<sup>23</sup> The Bank of England pays no interest on deposits. The law does not require that any particular amount of reserve be held by either the Bank of England or by the joint-stock banks, but the Bank of England has found that its safety line ranges between 33% and 47% of its liabilities, while the other banks' reserves range from about 10% to 15% of their liabilities.<sup>24</sup>

The Bank of England serves as fiscal agent of the British Government, it discounts Treasury bills, and performs other functions for the government. It maintains eleven branches in the principal cities of England. In spite of its private ownership and management the Bank does not make its primary aim that of earning a profit for its stockholders. It recognizes its responsibility as the central bank of Great Britain, and its duty of regulating the currency and credit system in the interest of the general welfare.

**Control of the Money Market by the Bank.**—One of the ways in which the Bank of England controls the money market and protects the British currency system is through its rate of discount, the so-called "Bank rate." This is the rate at which the Bank buys approved bills from its customers, or in other words supplies funds to the market. To be eligible for discount at the Bank of England a bill must bear at least two good British names, of which one must be the acceptor. If the Bank feels that market rates are too low and that lending is going on too freely (and prior to 1931 that perhaps as a consequence gold was leaving the country too rapidly and foreign exchange was under pressure), the Bank may raise its rate of discount, that is, the rate at which it will lend money.

The joint-stock banks do not borrow directly from the Bank of England. They maintain sizable secondary reserves in the form of call loans to the bill brokers or dealers which are secured

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<sup>23</sup> The five banks which dominate commercial banking in England are in order of size: Midland Bank, Ltd., Lloyds Bank, Ltd., Barclay's Bank, Ltd., Westminster Bank, Ltd., and National Provincial Bank, Ltd. These are all larger than the Bank of England.

<sup>24</sup> Horace White (revised by Charles S. Tippetts), *Money and Banking*, New York, Ginn & Co., 1935, p. 744.

by acceptances. If the joint-stock banks need more cash, they call their loans from the bill brokers, who are thereupon forced to borrow at the Bank of England, paying the rate which the Bank has established.

The Bank rate is ordinarily maintained higher than the market rate for the same class of paper. The rate is, therefore, not much of a factor unless there is a stringency in the money market. It is in the nature of a penalty rate and discourages undue borrowing. The Bank, however, is prepared to grant to borrowers, at its rate, all the funds to which they are entitled.

If the market has plenty of money so that the higher "Bank rate" is ineffective, the Bank of England may engage in open-market operations; that is, it may send its agents out to sell securities in the market, withdrawing the proceeds, or perhaps it will borrow from the market giving consols as security. This may force the joint-stock banks to call their loans and the bill brokers thereupon to borrow at the Bank of England. The higher rates and the withdrawal of funds from the market by the Bank are said to create a vacuum, to be filled by money from abroad. A lowering of the rate, on the other hand, tends to have the opposite effect, to make money easy, and can be supplemented by buying securities from the market.

The effectiveness of the "Bank rate" is strengthened by the practice of the banks of basing their deposit and loan rates upon the Bank rate. Thus the rate of interest paid by London banks is usually 2% below the Bank rate. The psychological effect of Bank rate changes is also important as a control device.

A few days prior to the outbreak of war the Bank raised its rate (August 24, 1939) from 2% to 4%, as had been the historic custom in periods of war and crisis, the reason being to discourage the rush to liquidity and to check unnecessary credit expansion. The move was severely criticized by John Maynard Keynes and other disciples of low interest rates, who urged that the war be financed with cheap money. In September the rate was lowered to 3% and in October, back to 2%.

**Exchange Equalization Fund.**—The suspension of gold payments in 1931 left the pound open to wide fluctuations and a

prey to international speculation and other erratic influences. To counteract these forces, since an unstable pound is damaging to trade and to the country generally, the Issue Department of the Bank of England bought and sold foreign currencies and gold. It entered the exchange market as either buyer or seller, i.e., on the demand side or supply side, according to whichever seemed appropriate. It soon became evident, however, that the resources of the Bank were not sufficient to smooth out fluctuations in sterling without the assumption of more risk than appeared wise. Consequently, in April, 1932, a special "Exchange Equalization Account" was voted by the government, and began operations in June, 1932. It was originally limited to £175,000,000, plus £25,000,000 from the former Dollar Exchange Reserve, but in May, 1933, after the United States left gold, the amount was increased to a total of £375,000,000 when the House of Commons voted an additional £200,000,000.<sup>25</sup> It was subsequently increased still further.

The effects of gold imports or exports upon bank reserves were offset by operations of the Fund. When it bought gold it sold Treasury bills, and the money received for the bills was withdrawn from the market, thereby offsetting the money paid out for the gold. Conversely, when gold left the country the Fund bought Treasury bills, thereby putting cash into the market. Its operations in gold were balanced by its operations in Treasury bills, so that the market neither gained nor lost any cash.

As noted above, in January, 1939, £200,000,000 in gold were transferred from the Bank of England to the Exchange Fund, which paid for the gold with government securities. The gold which remained in the Bank was then revalued from 84s 10½d per fine ounce, to the market price of about 148s per ounce. The Bank's gold, according to the Currency and Bank Notes Act of February, 1939, was to be revalued each week, and any profit or loss was to be absorbed by the Exchange Fund. The Fund had already followed the practice of valuing its own gold holdings according to the market value. This gold operation, following

<sup>25</sup> John T. Madden and Marcus Nadler, *The International Money Markets*, New York, Prentice-Hall, Inc., 1935, pp. 294-297.

the practice of the United States and other countries, utilized the profits from gold devaluation for exchange stabilization.

When war broke out the Fund promptly withdrew support from the pound, which had been maintained at approximately \$4.68. The pound then depreciated rapidly, but was soon officially pegged at about \$4.02½-\$4.03½. On September 1, 1939 the Currency (Defense) Bill was passed, which provided that the resources of the Exchange Fund were to be available for war purposes. The Chancellor of the Exchequer announced a few days thereafter that £280,000,000 in gold was being transferred from the Bank of England to the Exchange Fund. The Fund's resources were drawn upon to help pay for goods purchased abroad, especially in the United States. After 18 months of war the Fund's resources were exhausted.

During the period of its active operation the Fund was fairly successful in reducing fluctuations of the pound. The Fund, however, did not attempt to interfere with a general trend one way or the other. To undertake to do this and go against a lack of equilibrium in British foreign payments and against fundamental conditions, would have been difficult and expensive, if not ultimately fatal to the Fund. Operations of the Fund were necessarily kept secret. The Fund was managed by the Bank of England, and was able to maintain exchange rates reasonably stable.

## CHAPTER 39

### THE ECONOMY OF FRANCE

**France as a Commercial Nation.**—Prior to the war France was one of the leading maritime nations. Bordering on the Mediterranean, the country was well located for carrying on trade with the various Mediterranean regions, and with the countries of the East. France was also an active participant in the important North Atlantic trade, the distance between French ports and American ports being in some cases less than between British and American ports. In foreign commerce France ranked fourth among the nations of the world, its trade being exceeded by that of Great Britain, the United States, and Germany.

From the standpoint of dependence on other nations, France presents a striking contrast to Great Britain. The British economy is exceedingly specialized and dependent, while that of France is unspecialized and to a large degree independent. This fact accounts in part for the less important position of France in world trade than that of Great Britain. In France the small *entrepreneur* and the small farmer are characteristic of the country, and exert a certain amount of stability upon French political life.

**Agriculture.**—Unlike Great Britain, France produces almost all of its own food. Agriculture is the leading economic activity. France has more farm land of good quality than any other European country, with the exception of Russia. Almost half the land of France is under cultivation, and about a fifth is used for pasturage.<sup>1</sup> Nearly 40% of the population is engaged in

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<sup>1</sup> R. H. Whitbeck and V. C. Finch, *Economic Geography*, 3rd ed., New York, McGraw-Hill Book Co., Inc., 1935, p. 359.

farming, and most of the farms are tilled by their owners, a condition which fosters social stability.

The absence of specialization is particularly noticeable in agriculture. France produces a wide variety of products, vegetables, fruits, grains, livestock, and dairy products. In wheat production, France ranks second among European countries, being preceded by Russia. Nearly one-tenth of the entire area of France is devoted to the raising of wheat. The amount of potatoes grown in France is almost equal to the amount grown in the United States, but the French *per capita* consumption is three times that of this country.<sup>2</sup> Sugar beets are also produced in large quantities. In southern France, flowers are raised for northern centers and for the making of perfume, much of which is normally exported.

France produces more wine than any other European country. The principal wine-growing districts are in southwestern and south central France, where much of the land is well suited to the culture of wine grapes. Notwithstanding the huge domestic production, France imports more wine than it exports, home consumption being great. A large portion of the wine imported is blended with domestic wines.

France is also an important producer and exporter of butter and cheese. French cheeses are well known throughout the world. Roquefort cheese, made from sheep's milk and ripened in underground caves, is produced in southern France—about 20,000,000 pounds of this cheese being produced annually. The Camembert and Brie cheeses are produced in the north.

**Natural Resources.**—France is moderately well endowed with natural wealth, having an abundance of high-grade iron ore and a fair supply of coal. This is the reverse of the situation in Great Britain and pre-war Germany, which have vast coal reserves but only moderate amounts of iron. The iron reserves of Lorraine are nearly equal in extent to those of all the rest of Europe.<sup>3</sup> With the return of Alsace-Lorraine to France in 1918, Germany lost over two-thirds of its iron ore. The coal

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<sup>2</sup> *Ibid.*, p. 361.

<sup>3</sup> *Ibid.*, p. 362.

supply of France is inadequate for French needs. It is expensive to mine, and not of high quality; hence France regularly imports about one-quarter of the coal used. To some extent the deficiency of coal has been offset by the development of water power, of which France has large potential reserves. France before the war developed more hydroelectric power than any other European country except Italy.<sup>4</sup>

France has few metals other than iron, antimony, and bauxite from which aluminum is made. The United States and France are the two leading producers of bauxite. The name *bauxite* is derived from the town of Baux in France, where the deposits were discovered in 1822. France has no copper, manganese, nickel, chromite, tungsten, tin, or mercury, and only small reserves of lead and zinc.<sup>5</sup> The only other mineral which France exports in large quantities is potash, France being one of the few world sources of this material. Chemical products loom large in the export trade of France, and prior to the war the value of the chemical group was far greater than that of any other export. The chemical industry developed rapidly in France after the first World War.

**Merchandise Exports.**—The Industrial Revolution developed much later in France than in Great Britain, and never attained the proportions found in Great Britain, Germany, or the United States. Generally speaking, the French are an artistic people who do not seem to have the same interest in large industries as do Americans. French characteristic manufactures and export goods have not been standard, staple articles, but such items as perfumes, wines, fine cotton fabrics, women's clothing, silks, laces, tapestries, jewelry, cut glass, and other goods of a luxury or semi-luxury character combining high value with low bulk. Chemical production has forged ahead rapidly and chemical products have been the principal export of France.

Manufactures of this type are subject to wide fluctuations in demand. Sales are large during periods of prosperity, but drop

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<sup>4</sup> *Ibid.*, p. 365.

<sup>5</sup> Brooks Emeny, *The Strategy of Raw Materials*, New York, The Macmillan Co., 1934.



off sharply during depression. This has tended to make French trade peculiarly susceptible to business changes.

After about 1920 industry in France expanded greatly, and steel manufactures assumed a prominent place among French exports. France is an important manufacturer of textiles, although its textile industry suffered much from world competition in recent years. French cotton fabrics are of fine quality, and ranked third among French exports. France is also a leading producer of fine woolens, importing most of the raw wool. In the manufacture of silk, France ranked first among European countries. The principal customers of France in 1938, the last full year before the war, are shown in Table 22.

TABLE 22. DESTINATION OF FRENCH EXPORTS, 1938<sup>6</sup>

	Franks
French colonies .....	8,399,000,000
Belgium .....	4,182,000,000
United Kingdom .....	3,551,000,000
Switzerland .....	1,924,000,000
Germany .....	1,850,000,000
United States .....	1,681,000,000

**Merchandise Imports.**—The foreign commerce of France grew rapidly after 1850, but lagged during the last quarter of the century. After about 1900, however, trade again expanded. For many years prior to the war France had an excess of merchandise imports, and while less dependent than Great Britain upon foreign goods, the country's economy was, nevertheless, vitally dependent upon some of the imported articles.

Coal was the leading import of France, and important since France is an industrial country. The five chief imports were all industrial raw materials with the exception of wines, and these were not for final consumption but were used largely for blending with the domestic products. In the three years 1934–1936, raw materials comprised 52% of total French imports, food and drink 31%, and manufactured goods 17%.<sup>7</sup> In 1913,

<sup>6</sup> Figures are from the *Statesman's Yearbook*.

<sup>7</sup> Computed from figures in *Europa*, Vol. I, p. 120\*.

the proportions were: raw materials 59% of total imports, food and drink 21%, and manufactures 20%.<sup>8</sup>

France bought nearly one-third of its imports from its colonies. After the colonies, the United States ranked first as the source of French imports. The other leading exporters to France were Great Britain, Belgium and Germany (Table 23).

TABLE 23. SOURCES OF FRENCH IMPORTS, 1938<sup>9</sup>

	Francs
French colonies .....	12,466,000,000
United States .....	5,235,000,000
United Kingdom .....	3,238,000,000
Belgium .....	3,159,000,000
Germany .....	3,116,000,000

**Balance of Payments.**—Since 1875, the French balance of trade has been unfavorable, that is, France has had an excess of merchandise imports.<sup>10</sup> During the few preceding years the excesses of exports were probably due primarily to the export of capital from France in connection with the payment of the indemnity to Germany following the Franco-Prussian War of 1871. In many of the years prior to 1914, merchandise imports were not greatly in excess of exports, but during the first World War and after the depression, beginning in 1929, the balance was heavily unfavorable.

TABLE 24. MERCHANDISE TRADE OF FRANCE<sup>11</sup>

Date	Exports	Imports	Excess of Imports
1932 .....	19,705,000,000	29,808,000,000	10,103,000,000
1933 .....	18,474,000,000	28,431,000,000	9,957,000,000
1934 .....	17,311,000,000	23,097,000,000	5,786,000,000
1935 .....	15,496,000,000	20,974,000,000	5,478,000,000
1936 .....	15,454,000,000	25,398,000,000	9,944,000,000
1937 .....	23,940,000,000	42,312,000,000	18,372,000,000
1938 .....	30,586,000,000	45,981,000,000	15,395,000,000

<sup>8</sup> *Europa*, Vol. I, p. 120\*.

<sup>9</sup> Figures are from the *Statesman's Yearbook*.

<sup>10</sup> In 1905 France had a small excess of exports.

<sup>11</sup> *Europa*, Vol. I, p. 120\* and *Statesman's Yearbook*. Figures exclude re-exports.

During the first World War the great increase in imports was an increase in values rather than in quantities. This was due to the high prices prevailing. Exports continued at about the same value, but in quantity they declined drastically. In a balance of payments study the value figures are the ones considered. They indicate payments made and income received from abroad. Table 24 compares the value of goods exported with the value of goods imported for the years 1932-1938.

Invisible items figure prominently in French commerce. France before the war had a large merchant marine,<sup>12</sup> and shipping receipts were a substantial item which helped to pay for French imports. Another important invisible export was represented by the services rendered to the many tourists and travelers in France.

France also had extensive overseas investments so that interest and dividend payments provided a sizable income and accounted for part of the merchandise imports. A large portion of these foreign investments were made by the French Government as well as by French individuals and firms. Heavy investments were made not only in French colonies, but in countries which were, or had been, political allies of France, such as Czechoslovakia, Rumania, and Poland. Large investments were also made in Argentina, Mexico, and other countries. French foreign investments were often of a political character, employed to further political ends. This has been the case not only in long-term loans and investments but also in short-term advances.<sup>13</sup>

**Foreign Possessions.**—The foreign possessions of France rank in extensiveness next to those of Great Britain. By far the greater part of French possessions are located on the Af-

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<sup>12</sup> On June 30, 1939, the French merchant marine consisted of 2,934,000 gross tons.

<sup>13</sup> Foreign issues of long-term securities could not be listed on the Bourse or other French stock exchanges without the permission of the Minister of Finance. The Bank of France, which frequently made short-term advances to foreign countries, was sensitive to the wishes of the French Foreign Office. Illustrations of short-term withdrawals apparently effected for political considerations are discussed by Paul Einzig in *Behind the Scenes of International Finance*, London, Macmillan & Co., Ltd., 1932, and by John T. Madden and Marcus Nadler in *The International Money Markets*, New York, Prentice-Hall, Inc., 1935.

rican continent and include Algeria, Morocco, much of the Sudan, several colonies in western Africa, and the large island of Madagascar. French dependencies in Africa cover slightly more territory than the British African dependencies.

Algeria, on the north African coast and one of the most important of the French dependencies, is larger than France proper. From Algeria, France ordinarily imports wheat, vegetables, fruits, nuts, tobacco, wool, cotton, and wine. Foodstuffs are also imported from the protectorate of Morocco, another large possession, which lies to the west of Algeria. French West Africa, farther south, has great tropical forest resources, and exports cacao, coffee, peanuts, palm kernels, and other tropical products. Madagascar, which is also larger than the mother country, exports vanilla, cacao, cloves, mica, and graphite.

French "assimilated colonies," such as Algeria, French Indo-China, Madagascar, Guadeloupe, Martinique, and French Guiana, are within the same tariff system as France proper. They maintain free trade among themselves and impose the same duties on imports coming from non-French countries that France imposes. Certain dependencies, such as Senegal and French Guiana, offer preferential duties to imports from France. The open door (equal treatment to all countries, including the mother country) prevails in other French colonies, such as French Morocco, French West Africa, French Indo-China, and part of French Equatorial Africa.

**Currency System.**—The currency unit of France is nominally the gold franc, which, for many years prior to the first World War, was equal to 19.2948 cents in American money. The franc is divided into 100 centimes. The franc has been devalued successively, and at present has no fixed gold content. Like the currencies of most other countries the franc is a paper unit whose value is controlled by the government. When Germany conquered France in the spring of 1940 the franc was worth a little over two cents in American money.

According to a rigid definition of the gold standard, France has never been completely upon the gold standard. Until 1873, as a member of the Latin Monetary Union, France had the

bimetallic standard. But with the fall in the price of silver and the consequent difficulty in keeping the two metals circulating side by side at the mint ratio, France closed its mints in 1873 to the free coinage of silver. This measure did not establish the full gold standard, since there existed a large amount of silver coins which were legal tender but which were not redeemable in gold. This was the situation which prevailed in 1914. France was commonly said to be on the "limping standard," since according to the law all contracts involving payments of money, including bank notes and deposits, could be satisfied by the payment of silver coin, and the government was not required to redeem the coin in gold. In practice, however, the silver coins were kept approximately on a par with gold so that according to more liberal definitions of the gold standard—that is, effective parity of all forms of money with a fixed amount of gold—France may be said to have had the gold standard.

The Bank of France suspended specie payments on August 5, 1914 as a war measure to avoid depletion of its reserve. At the same time, the legal limit to the amount of notes which the Bank might issue was raised from 6,800,000,000 francs (fixed in 1911) to 12,000,000,000 francs. Other measures raising the limit followed at frequent intervals, with the result that inflation in France commenced at the very outset of the war.<sup>14</sup> As the Bank of France made advances to the government and deposits expanded, the deposits of the large private banks in France also expanded. Deposits of the Bank of France increased from about one billion francs during the first part of 1914 to four billion francs by the middle of 1918, the high point until after the war.<sup>15</sup>

The inflation in France during and after the war was both currency and credit inflation. The use of checks had never been developed in France as it had in the United States and elsewhere, so that the increases in the note circulation were an im-

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<sup>14</sup> Exchange rates remained fairly stable until after the close of the war, having been pegged with the financial assistance of Great Britain and the United States.

<sup>15</sup> For a fuller discussion of French war and post-war finance, see John Parke Young, *European Currency and Finance*, Washington, D. C., Government Printing Office, 1925, Vol. I.

portant part of French inflation, the notes being issued largely against government obligations. Thus, note circulation of the Bank of France increased from less than seven billion francs at the beginning of the war to about thirty billion francs at the close of the war. Later, note circulation greatly increased beyond the wartime maximum. Because of the increased currency and credit, wholesale prices in France increased by over three and one-half times during the war period, and later attained much higher levels.

Following the war, the support behind exchange rates was removed and the rates dropped disastrously. The average price in New York of cable transfers on Paris fell from about 18.38 cents at the time of the Armistice in November, 1918, to 10.62 cents in November, 1919 and to 6.01 cents in November, 1920. By the middle of 1926, the franc was worth less than 2 cents in American money. The struggle against the depreciation of the franc and its final *de facto* stabilization in 1926 at a value of 3.92 cents in American money have been described in Chapter 36.

In June, 1928, France formally adopted a gold-bullion standard, which recognized the parity achieved eighteen months before. Hardly had France accomplished this monetary reform when the country was confronted with world-wide depression. The effects upon French currency have already been discussed in Chapter 37. France was forced to devalue the franc again, in September, 1936. In the Spring of 1937 the franc was slipping, and in July, 1937 the franc was allowed to seek a still lower level. In view of the depreciation of the franc, the gold holdings of the Bank of France were revalued in the Fall of 1938, the profit going to the government and being used to repay advances from the Bank.

The franc continued downward and when war broke out in the Fall of 1939 was worth about 2.5 cents in American money. For the first few months of 1940, prior to the invasion of France by Germany, the franc averaged 2.08 cents. Thereafter France was cut off from trade with most of the world.

The requirement that the Bank of France maintain a gold reserve of 35% against its demand liabilities was suspended by

government decree September 2, 1939. The note circulation of the Bank increased rapidly, from 123,000,000,000 francs at the end of July, 1939, to about 160,000,000,000 francs at the time the country was overrun by Germany in the Spring of 1940, and to about 319,000,000,000 francs in August, 1942.

Prices in France rose sharply during the years prior to the war, as can be seen in Figure 12, p. 638. The index number of wholesale prices averaged 338 for 1935, and by August, 1939, had doubled, standing at 674. For the first 8 months of 1940 prices averaged 681; no data are available thereafter.

**The Bank of France.**—The Bank of France was founded in 1800 by Napoleon Bonaparte, and in 1803 was given a monopoly of note issue in Paris. In 1848, the *départemental* banks were incorporated with the Bank of France, which then became the sole bank of issue in France. Inasmuch as the public did not use deposits extensively but preferred currency, the monopoly of note issue was an important privilege, and narrowed the field for other banks. In fact, this monopoly retarded the development of banking in France.

The Bank of France is privately owned, although the government has an important voice in its management. The government's participation in the Bank dates from 1806, when a measure was adopted providing that the governor and two sub-governors be nominated by the government. This gave the government control of the Bank which it has retained ever since. Like the Bank of England, the Bank of France serves as fiscal agent for the government as well as a central bank for other banks.

In the so-called "French new deal" under Premier Léon Blum, the social reform laws included a law passed in July, 1936, which partially nationalized the Bank of France. For many years, regents (directors) of the Bank had been elected by the 200 largest stockholders. As there were in the beginning only 300 stockholders, this provision originally resulted in little dissatisfaction. Since, however, in recent years the Bank has had over 40,000 stockholders, there was widespread agitation for reform. The new law abolished the directors elected by

the 200 stockholders, and in their place substituted a board of directors which obtain their three-year offices in various ways. Sixteen of the twenty directors consist of representatives of the government and leading economic groups, one is chosen by the savings banks, one is elected by the Bank's employees, and two are elected by the entire stockholding group, each stockholder having only one vote.<sup>16</sup>

Not only is the Bank of France a central bank, but it is the largest commercial bank in France, having over 600 branches and subsidiary offices. The Bank does a large business with individuals and firms as well as with other banks. Any properly identified person may open an account with the Bank of France.

The dominant position in French finance occupied by the Bank of France is to a large extent the result of the vast number of bills discounted and rediscounted. It buys, or discounts, all eligible bills offered to it at its discount rate. To be eligible for discount at the Bank of France, a bill must run for not longer than three months and must bear the signature of three solvent persons or firms. The third signature on a bill is usually that of the bank which presents the bill for rediscount, having already advanced funds to an individual or firm by discounting the bill. The bank's profit is the difference between the rate charged its customer and the rate charged by the Bank of France. Two-name paper is acceptable if backed by eligible securities. Bills are not refused because of their small value, and the Bank does a large business in bills of small amounts. No distinction is made between bankers' acceptances and trade acceptances. Unlike the Bank of England, the Bank of France makes no distinction between domestic and foreign bills, and in time of financial strain foreign banks have frequently borrowed funds by having bills discounted at the Bank of France. In this way, large short-term advances have been made abroad.

In its credit policy as a central bank, the Bank of France relies almost entirely upon its discount rate. Unlike the Bank of England and the Federal Reserve Banks, the Bank of France

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<sup>16</sup> These reforms are discussed in detail in *Foreign Affairs*, October, 1936, pp. 155-164. The text of the law appears in the *Federal Reserve Bulletin*, September, 1936, p. 705.



has but limited authority to engage in open-market operations. This restriction of its power is not as great a handicap as might be supposed, however, since the French discount rate is ordinarily a more direct and powerful instrument of control than the rates of the Bank of England and of the Federal Reserve Banks. In the first place, the Paris money market is in a much less advanced stage of development than the London market, with the result that French businesses in need of financial accommodation generally borrow from banks rather than in the open market. Discounting at banks is thus the ordinary way of obtaining funds. Hence, while not required to keep deposits with the Bank of France, French commercial banks as a rule maintain large balances there and take full advantage of their discount privileges in order to have a supply of funds to loan to their customers. In the second place, the use of checks has never been developed in France to nearly the extent that it has in the United States and England, bank notes being the principal medium of exchange. Bank notes can be issued only by the Bank of France. As a result, the banks are more dependent upon the Bank of France than if transactions were settled by checks. Consequently, changes in the discount rate of the Bank of France at once affect the cost of credit throughout the country.<sup>17</sup> The psychological effects of changes in the discount rate are also helpful in the rate's effectiveness.

Prior to 1914, the discount rate of the Bank of France was changed but rarely. If gold was leaving the country in what was considered to be excessive amounts, or if the gold reserve was in danger of being depleted, the Bank would exercise its option of redeeming its notes in silver. If an individual came at such times to get gold, the Bank would probably come to some agreement with him whereby he could have gold by paying a slight premium for it. This would tend to discourage the export of gold and obviate a rise in the discount rate.<sup>18</sup> This practice was known as the gold premium policy of the Bank. During the years 1898-1913, the French rate was changed only

<sup>17</sup> Branches of the Bank of France always maintain the same discount rate as the main bank.

<sup>18</sup> The gold which the Bank paid out was not French gold coin but bar gold or foreign coin.

fourteen times, while the Bank of England rate was changed 79 times. In this period the maximum French rate was  $4\frac{1}{2}\%$  and the minimum rate  $2\%$ .<sup>19</sup> After the first World War, financial disturbances in France and abroad resulted in more frequent and extreme changes in the Bank of France rate.

When the war began in 1939, the Bank's discount rate was  $2\%$ . It was not raised, but was continued at this level until March, 1941, when the rate was lowered to  $1\frac{3}{4}\%$ , where it has remained. The expansion in the Bank's note circulation during the war, especially after the occupation of the country by Germany, and the removal in September, 1939 of the requirement regarding reserves against notes, have already been discussed.

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<sup>19</sup> John T. Madden and Marcus Nadler, *The International Money Markets*, Prentice-Hall, Inc., New York, 1935, p. 301.

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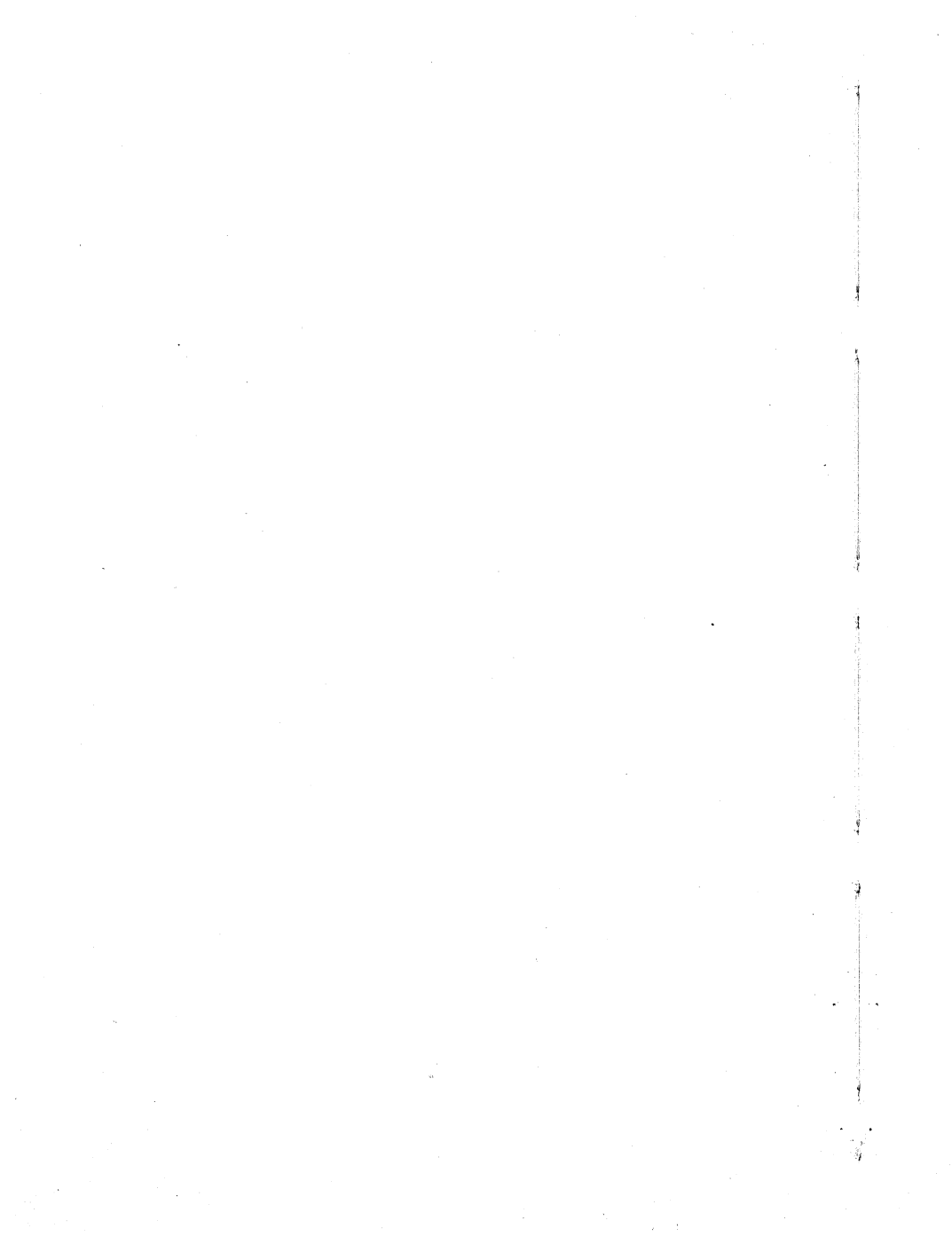
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